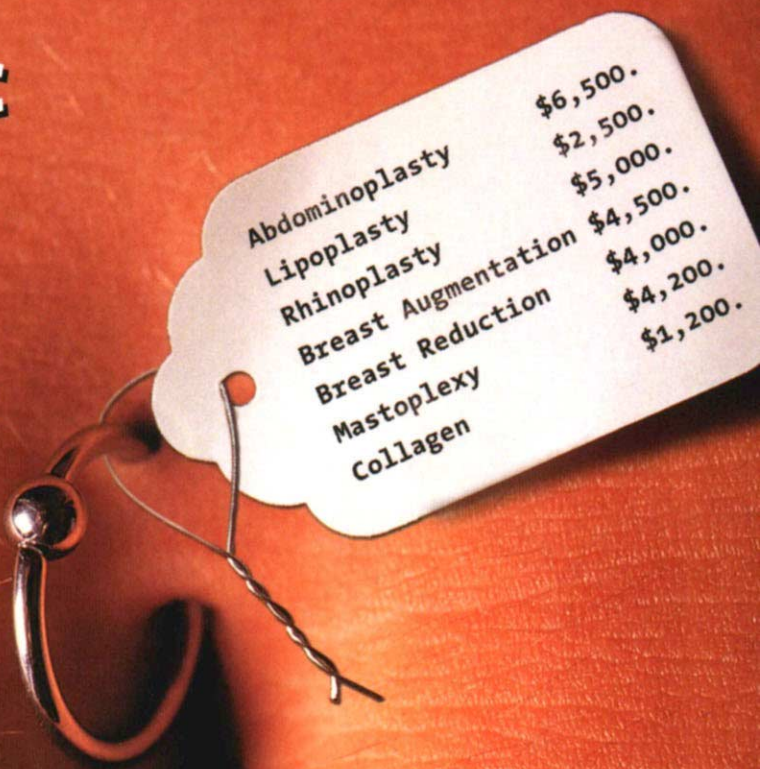
THE MILKEN INSTITUTE
Review
FOURTH QUARTER 1999
A JOURNAL OF ECONOMIC POLICY

The Aesthetic Economy



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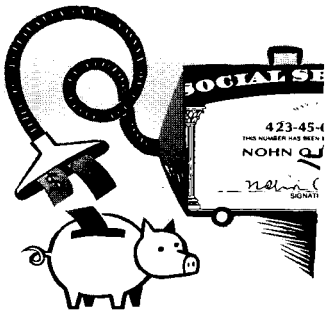

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EDITOR'S NOTE

Yes, the long wait for the fourth issue of The Milken Institute Review is over – and do we have a doozy* for you. First, admire our fabulous cover art. Next, surf your way through essays that run from the sublime (the new economics of aesthetics) to the ridiculous (America's overused bankruptcy laws). Better yet, read the magazine cover to cover. Of course, there'll be a prize for the first person to memorize the book excerpt.

Jagdish Bhagwati of Columbia University tackles the future of trade liberalization on the eve of the WTO's meeting in Seattle. As perhaps the most articulate defender of free trade on the planet, Bhagwati is always worth reading. And as the former economic policy advisor to the director-general of GATT, he has a pretty fair notion of what – if anything – can be done when Pat Buchanan, Ralph Nader and Greenpeace seem intent on demonizing globalization.

Virginia Postrel, the editor of *Reason Magazine*, is probably best known for her quirky, insightful columns on economics, technology, politics and culture – not to mention her book, *The Future and Its Enemies: The Growing Conflict over Creativity, Enterprise, and Progress* (Free Press, 1998). Here, she writes about the evolution of material values in an era of rising discretionary income and ever-cheaper design technology.

The good news, of course, is that everything from teapots to tummies is looking better. The bad news is that the arbiters of taste can't leave well enough alone. "The temptation to exercise political coercion to force one's aesthetic opinions on others can be overwhelming in the face of what seems ugly or inappropriate," she writes. "Instead of the classical proposition *de gustibus non disputandem est*, we may find ourselves in a world where matters of taste are our most intractable disputes."

Ben Bernanke (Princeton), **Frederic Mishkin** (Columbia), and **Adam Posen** (Institute for International Economics) ask what mere mortals can do to preserve price stability, once Alan Greenspan retires from Olympus. Not surprisingly, they believe there's hope. "We think the answer lies in a strategy known as 'inflation targeting,'" a policy approach "that has been employed with great success by countries including Canada, the United Kingdom, New Zealand, Australia and Sweden."

The authors want you to know (as does the editor) that anyone thirsting to know more about the subject can plunk down $24.95 for their book, *Inflation Targeting* (Princeton University Press), written with Thomas Laubach of the Federal Reserve Bank

*Always wanted to use that word in print...

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of Kansas City.

Walter Russell Mead, a senior fellow and resident gadfly at the Council on Foreign Relations, explains why emerging economies need a new model for development. Export-led growth has run its course, he argues – China and India can't make it the way Japan and Korea did. But there's no going back to "import substitution," which was inspired by the early successes of self-sufficiency and central planning in the socialist bloc.

So is there really a practical alternative? Mead fleshes out a third route to the Promised Land, requiring a shift from dependence on demand for manufactured exports, along with reforms that enable developing countries to use capital more efficiently while buffering national economies against international panics.

Joseph Pomykala, the associate director of the Center for International Business and Management at Towson University in Maryland, has been obsessing over the economics of bankruptcy ever since he wrote a Ph.D. thesis on the subject at the University of Pennsylvania. There are lots of reasons why one out of every 68 households in the United States filed for bankruptcy in 1998 – double the number of the entire decade of the Great Depression. "But the bottom line," he writes, "is depressingly simple: legal incentives make it much too attractive to shed personal debt through bankruptcy."

Now for something completely different: **Stephen Moore**, the director of fiscal policy studies at the CATO Institute, challenges the conventional wisdom that speed kills. Is this analysis of the consequences of higher speed limits properly classified as economics? Maybe. Is it an interesting take on government regulation? You bet – and that's a good enough reason to include it here.

This issue's book excerpt is from *True Security: Rethinking American Social Insurance*, just published by the Yale University Press. The authors, both law professors at Yale, are not your average pointy-heads. **Michael Graetz** is a former Treasury official in the Bush Administration and the author of *The Decline (and Fall?) of the Income Tax* (1997), a screed on the sad state of Federal taxation. **Jerry Mashaw**, a policy wonk who marches to his own drummer, is an outspoken advocate of a strong national government just when devolution is the flavor of the decade. His book, *Greed, Chaos and Governance* (1997), uses public-choice theory to expand on a theme first introduced by Alexander Hamilton.

Graetz and Mashaw start with a clean page, asking what we really want – and can reasonably expect – from the social safety net. "When planning our lives to maximize our own security," they write, "the long view may be prudent – or a formula for disaster. Individual responsibility is crucial, but it will not guard us against all hazards." The excerpt only sets the stage. Those who want to know in glorious detail what the pair recommends will have to buy the book. (Do you detect the emergence of a theme here?)

The puzzler is back: check out your feminist business IQ. So is the charticle – this time illustrating the difficulty of figuring out the role of bank credit in spurring (or destabilizing) growth. **Barry Bosworth** from Brookings reviews a couple of books on social insurance – including this issue's book excerpt. **Donald Straszheim** and **Michael Intriligator** plead for patience regarding China and Russia, while our superstar cartoonist, **Mark Alan Stamaty**, weighs in with a new Ekinomix.

Let me know what you think. The suspense is killing me (ppassell@milken-inst.org).

— Peter Passell

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BY JAGDISH BHAGWATI

Seattle will no doubt be sizzling despite the mild weather at the end of November. For that techno-trendy city is the site for the World Trade Organization's Inter-Ministerial Meeting – and more specifically, the place where the WTO's 134 member nations will attempt to kick off a new round of negotiations for liberalizing global trade.

Why the ado? This is, after all, the young organization's first trade round. What's more there will, no doubt, be an intense (if polite), public relations tussle over what the round should be called. If you're an American, the choice is between the Clinton Round, an opportunity that the President appears to have blown by procrastinating over whether he wanted a round at all, or the uninspired Seattle Round. If you are not an American, the preference, following the suggestion of Sir Leon Brittan, Europe's trade minister, is for the Millennium Round – and that's not just because it is apt to take a millennium to complete it.

But the reason the whole world will be watching is that both free trade and the World Trade Organization are under siege. Worse, the forces that threaten further trade liberalization under WTO auspices come from two altogether different directions.

Start with labor unions and other non-governmental organizations – in bureaucratize, the NGOs. The NGOs, constituting the civil (or as cynics would say, the uncivil) society, vary from the skeptical to the deeply hostile, calling into question the value of free trade (or "globalization" as they like to call it) and its premier institution, the WTO.

True believers want the WTO plowed under. They see it as the wicked arm of multinationals that want to impose the horrors of globalization upon us all. Lesser extremists oppose any new liberalization, preferring to de-fang the WTO rather than bury it.

Those in the moderate camp do not oppose the WTO or trade liberalization. But they would exact a considerable price for cooperating – namely, the obligation to link freer trade to labor and environmental standards, human rights and assorted social agendas. A big catch, of course, is that they do not all share the same views on what those agendas should be: One man's minimum living wage is another's right to starve.

More pointedly (and with greater consensus) the moderate NGOs are angling for a slew of procedural changes. These would include revising the WTO's dispute-settle-

JAGDISH BHAGWATI teaches economics and political science at Columbia University. His latest book, ***A Stream of Windows: Unsettling Reflections on Trade, Immigration and Democracy*** (MIT Press, 1998), won the Eccles Prize for Excellence in Economic Writing.

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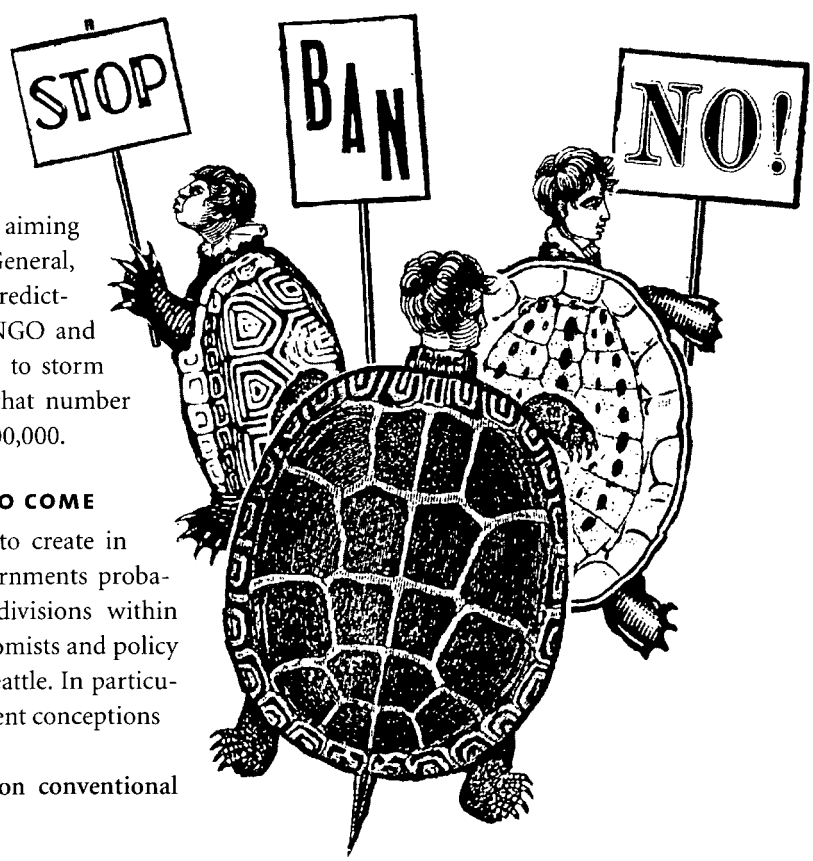
ment mechanism to allow NGOs to file "friend of the court" amicus briefs and to require environmental impact statements with every proposed trade pact.

Not all of the moderates' demands – particularly those for linkages to non-trade issues – are sensible. But many of them do lie within the bounds of a constructive debate over the trade-liberalizing agendas that most governments and economists will want to consider at Seattle. You can be sure, though, that the extremists will garner the bulk of the attention.

Reporters are already salivating at the rumor that some activists plan to march the streets of Seattle in turtle suits to demonstrate against the WTO's recent decision in the Shrimp-Turtle case. (In case you missed that one, the WTO is not happy about United States legislation unilaterally suspending rights to market shrimp harvested without the use of "turtle-excluding devices.") And do not rule out Japanese monster look-alikes – GATTzillas – or streakers aiming pies at the WTO Director-General, Mike Moore. First reports predicted that more than 10,000 NGO and union-backed warriors were to storm Seattle; by late September, that number had jumped to more than 100,000.



JOHN CRAIG

THE SHAPE OF THINGS TO COME

What NGOs can't manage to create in the chaos department, governments probably will. There are deep divisions within member governments, economists and policy wonks over the agenda in Seattle. In particular, there are strikingly different conceptions of its design and contents:

A core round focusing on conventional business – items that have been near the top of the free traders' agenda since the General Agreements on Tariffs and Trade was started after World War II. That would include further reductions in barriers to commerce in agriculture, manufacturing and services, as well as repairs to the dispute-settlement mechanism. The need for the latter has become manifest in view of the nasty squabbles between the United States and the European Community over bananas and hormone-fed beef.

A core-plus round that would include some of the "new issues" – the ones that fuel the ideological fires of assorted NGOs, labor unions and governments. Linkage of environmental and labor standards to WTO-protected market access tops this list, but it also includes issues dear to the hearts of

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Western policy wonks – agreements on rules for international investments and policing competition. (The Uruguay trade round itself had new issues: intellectual property protection, liberalization of trade in services and agriculture. These, for better and worse, have now become "old" issues for the WTO.)

It is fair to say that governments are divided between the two conceptions. India opposes a new round – which boils down to a very conservative view of what the core agenda should be in the next negotiations. The United States is not far off, differing from India mainly on the linkage of labor standards. Democrats, with the elections looming and the AFL-CIO commanding a huge campaign war chest, cannot but be craven to the union demands. By contrast, the Europeans, led by Sir Leon Brittan, are enthusiastic about the "core-plus" agenda.

Leaving aside politics, which is necessarily somewhat fluid, one might ask which of the two alternatives should be pursued. I would argue that the core agenda makes more sense.

PLENTY OF OLD ISSUES TO FIGHT ABOUT

Some analysts urge a broader negotiation on the grounds that it would put more on the table to haggle over, as in, "I give you access in services, you give me intellectual property protection."

Indeed, Fred Bergsten of the Institute for International Economics in Washington has argued that we have now reached the point where the rich countries have very few trade barriers and the poor countries have too many. So the tradeoff between rich and poor countries cannot be achieved on trade liberalization alone.

That is simply not true. Economists, among them Arvind Panagariya of Maryland, have demonstrated to my satisfaction that there is plenty to bargain about without adding fresh grist for argument. Some stiff industrial tariffs remain in place, notably in textiles, and the rich-country tariffs on agriculture are appallingly high. Moreover, the liberalization of trade in services has barely begun. If, as Director-General Moore has urged, we can be generous in reducing trade barriers of special interest to developing countries, so much the better.

There is plenty to bargain about without adding fresh grist for argument. Some stiff industrial tariffs remain in place, notably in textiles, and the rich-country tariffs on agriculture are appallingly high.

Add, of course, the much-needed reform of the dispute-settlement mechanism (where consensus is going to have to be forged on contentious issues such as how to handle genetically modified products), and we have a really compelling agenda for the next three years. That three-year time frame, incidentally, fits well into Moore's schedule, since he

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must split the six-year director-general's term with Dr. Supachai Panitchpakdi of Thailand.

Second, we no longer have the "GATT is Dead" threat from regionalism – the argument that without new issues at the multilateral level, all the liberalization action would end up in regional trade negotiations. Regionalism is even regarded by many as a cancer to be suppressed because proliferating regional preferences are undermining the economic logic of open trade. At the very least, then, there is regionalism-fatigue. And the World Trade Organization is more prized an institution than the General Agreement on Tariffs and Trade ever was.

Third, there is little prospect that any consensus could be hammered out on the new issues. A pact on investment policy, drafted by the rich countries at the Organization for Economic Cooperation and Development, is bitterly opposed by the NGOs. It is, in fact, overly ambitious in laying down the rights of multinationals while underplaying both the rights of host countries and the obligations of multinationals to local employees and communities.

Note, too, that the OECD investment proposal is a voluntary code. If blessed by the WTO, it would become mandatory and the objections to it would become even more vociferous. It is therefore a non-starter for Seattle.

Competition policy is really a North-North issue, prompted mainly by Washington's unhappiness with Japan and the difficulty in penetrating its clubby markets. However, the main division here comes between the United States Department of Justice, which would like to handle the problem through antitrust laws, and the Europeans who would like to see the WTO tackle it. It is unlikely that these fundamental differences, already closely identified with powerful political personalities, could be resolved in a three-year time frame.

If you think investment and competition would be tough nuts to crack, linkages aren't even worth attempting. The primary opposition comes from the poor nations – from their policy intellectuals and even some NGOs who see links between trade and environment and labor-standards as a back door form of protectionism. Many of them would opt for what I have called "appropriate governance" from alternative institutions such as the International Labor Organization, UNICEF, UNEP and other agencies set up for the job.

Opposition to the core-plus agenda needn't be based on where you stand on the new issues, but on whether you think change is possible. It seems highly unlikely that any compromise can be struck any time soon on the new issues – whether or not rich-country activists strut around Seattle in turtle suits. I, for one, am not sorry.

The most practical approach, then, is one in which negotiations advance on two tracks. The first track – the one that actually defines the new round – would stick to what I have labeled the core issues. Then there could be a separate track, where more contentious issues including the dismantling of the abominable "anti-dumping" laws, inescapable conflicts between trade and environmental values and the right to file amicus briefs in trade disputes can continue to be explored without holding the trade round hostage.

With free traders on the defensive, it is easy to lose perspective. The fact is, though, the most solid grounds for agreement on trade liberalization – mutual advantage – still exist. Now as before, the real problem is assembling coalitions with the power to get the job done and the wisdom to compromise in the name of the greater good. M

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The real estate

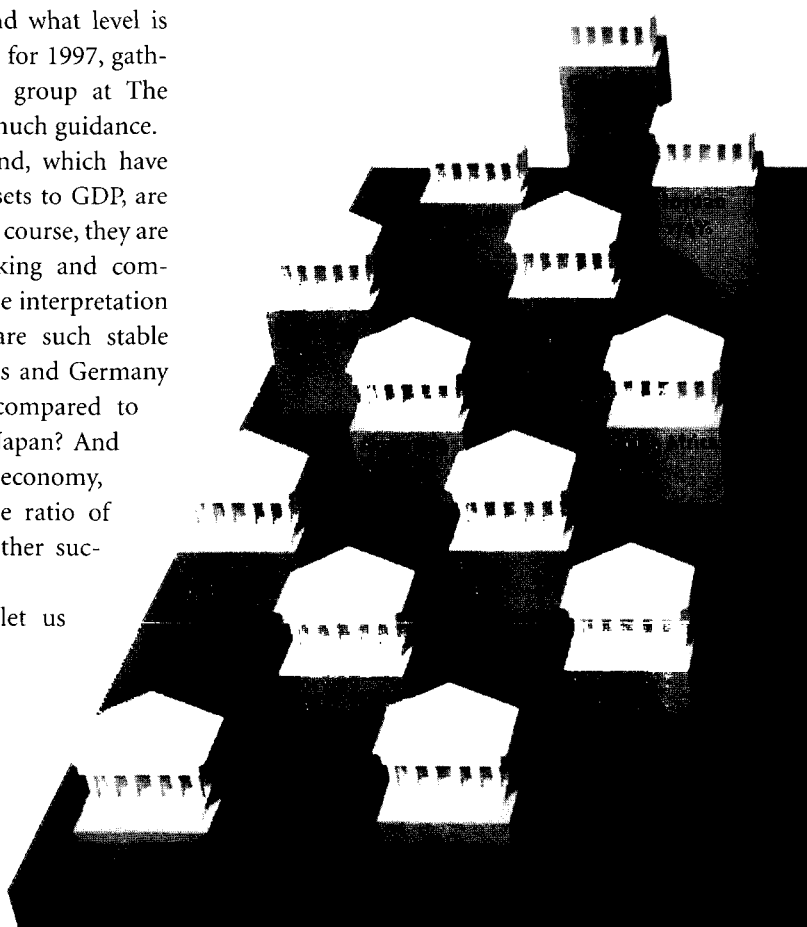
and stock market bubbles in East Asia, we are told, were fed by excessive bank lending. Ditto in Japan, where banks are now so far underwater that they are refusing to provide credit for any corporation that really needs it. On the other hand, it is economic gospel that successful modern economies need banks to serve as efficient financial intermediaries – and that an underdeveloped banking system is a serious impediment to growth.

So where is the golden mean? What level of credit creation is enough, and what level is too much? Alas, the numbers for 1997, gathered by the capital markets group at The Milken Institute, don't offer much guidance.

Hong Kong and Switzerland, which have the highest ratios of bank assets to GDP, are very successful economies. Of course, they are also global centers for banking and commerce, which may mess up the interpretation a bit. But why, pray tell, are such stable economies as the Netherlands and Germany swimming in bank assets compared to overextended Thailand and Japan? And why is it that one successful economy, Belgium, has three times the ratio of banks assets to GDP as another successful economy, Australia?

Once you figure it out, let us know.

— Thanks to Jim Barth and Glenn Yago



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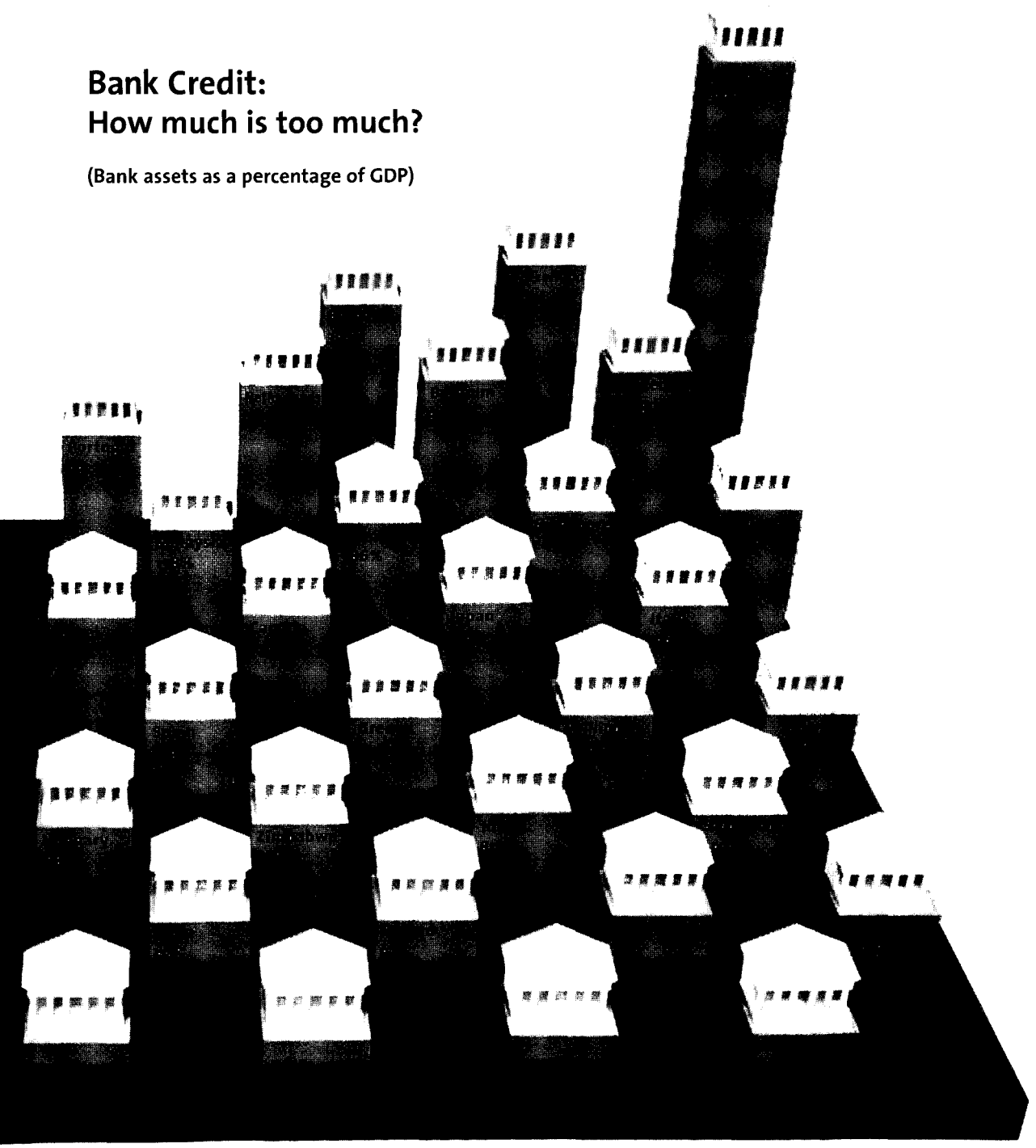
Bank Credit:
How much is too much?

(Bank assets as a percentage of GDP)



BRUCE SANDERS

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THE AESTHETIC ECONOMY

Beauty is not skin deep

Michael Graves' teapot for Target

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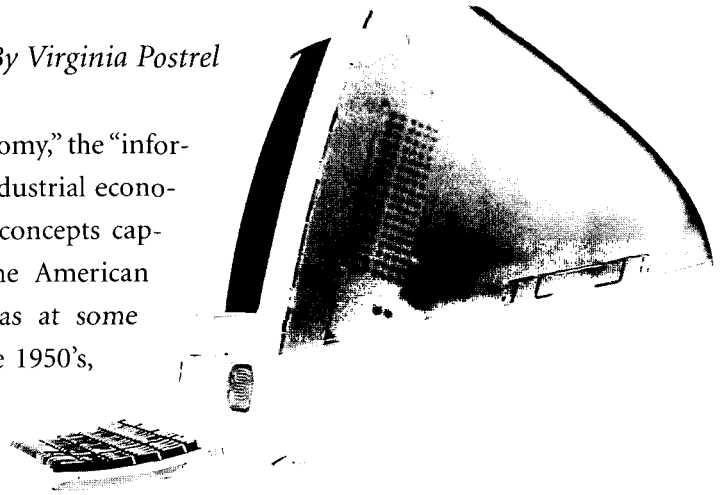
By Virginia Postrel



Apple's iMac

We've all heard about the "new economy," the "information economy," and the "post-industrial economy." Fuzzy though they are, these concepts capture the widespread sense that the American economy today is not what it was at some touchstone period in the past – the 1950's, perhaps, or the 1890's. People work in different jobs; productivity needs different measures; industry structures have changed.

All no doubt true, but also over-hyped. The whole economy can't be encapsulated in a catch phrase, and economic revolutions do not occur once a quarter. The claims that usually accompany such labels lead serious observers to scoff.

But the forces driving economic growth do evolve over time. The resulting changes can affect everything from the makeup of the labor force to the validity of national income statistics, from the location of industrial centers to the sources of political conflict. And one of the most profound such trends has gone virtually unremarked: the increasing importance of aesthetics, a value barely recognized in economic statistics but easily observable in business trends.

For example, when the business magazine *The Industry Standard* published its 1999 list of the most important people in the Internet world, the hardware-developer award went not to an engineer but to an art director, Teiyu Goto of Sony. Goto, the designer of the Playstation, had another big hit in 1999 with the sleek, featherweight Vaio notebook computer.

Silver and lavender (purple is Goto's favorite color), with a magnesium alloy case and a stylized, curvy logo, the Vaio is the sort of sensuous product that inspires consumers' gadget lust. Goto himself is smitten with the little computers: "I can't help patting them," he told the on-line magazine *AsiaBizTech*. In a market where computers have become a commodity that resists branding, the Vaio is designed not just as a tool but as a form of personal expression. The idea, says Goto, was to create a "thin and groovy notebook," whose ecstatic owners would "want to dash out of their rooms with it." The Vaio's light weight is impressive, but so is the way it looks. This computer evokes an emotional response.

Thanks to supply and demand, good design is everywhere

Like Apple's iMac, the Vaio marks a new era in the industry – one in which computers are finally moving beyond the dull functionality of the office PC while signaling broader trends. Technology and competition are driving down the cost of beauty, just as rising affluence is allowing us to buy more of it. We are demanding better aesthetics just about everywhere, from interoffice memos to restaurants.

LEFT: COURTESY OF TARGET STORES; TOP: HUNTER FREEMAN

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THE AESTHETICS ECONOMY

"When you're selling computers based on their personality and color choices, these are new rules," says Mark Dziersk, president of the Industrial Designers Society of America – one in which form matters as much as function. "We're seeing design creep into everything, *everything*." The number of industrial designers employed has jumped 32 percent over the past five years, according to a survey by Drexel University, and the society's membership is up 41 percent, to 3,118 in 1999.

We are seeing design creep into everything, *everything*.

There aren't enough applicants to fill all the jobs, says Dziersk. And while designers do more than make things pretty, he acknowledges that the current boom is "mostly about aesthetics."

The aesthetic economy shows up in products, in places such as restaurants and shopping malls, and in standards of personal beauty. Among the most dramatic signs is the surging demand for cosmetic surgery, a medical service whose value to consumers is demonstrated by the fact that it is rarely covered by insurance and must be paid for like shoes or movie tickets.

The number of cosmetic procedures in the United States increased by 153 percent from 1992 to 1998, to more than one million a year, according to the American Society of Plastic and Reconstructive Surgeons. Liposuction, the most popular cosmetic surgery, which involves removing excess fat, jumped 264 percent in the same period, to about 172,000 procedures in 1998. Demand is high despite the price tag. The average surgical fee for liposuction was almost $1,900 per site (a chin, say, or one thigh), not including anesthesia and operating room services. And liposuction is one of the cheapest cosmetic procedures.

VIRGINIA POSTREL (vpostrel@reason.com) is the editor of *Reason Magazine* and the author of *The Future and Its Enemies: The Growing Conflict over Creativity, Enterprise, and Progress* (Free Press, 1998).

THE VALUE OF PRESENTATION

In the 1930's, the industrial designer Harold Van Doren explained that "design is fundamentally the art of using lines, forms, tones, colors and textures to arouse an emotional reaction in the beholder." That is too narrow a definition, because it ignores the art of achieving that result within ergonomic, manufacturing and cost constraints. But it's a pretty good start for aesthetics, especially in the economic context.

Starbucks, for example, has built its brand not just on coffee but on a distinctive style for its establishments that combines rich earth tones with the precise lines and luxurious textures of high-end office design. The company has had an in-house department of designers and architects since 1991. "Every Starbucks store is carefully designed to enhance the quality of everything the customers see, touch, hear, smell or taste," explains CEO Howard Schultz. "All the sensory signals have to appeal to the same high standards. The artwork, the music, the aromas, the surfaces all have to send the same subliminal message as the flavor of the coffee: Everything here is best-of-class."

Aesthetics is about presentation – about the way we communicate through the senses. It is about perception, not cognition or usefulness, though it may affect both. And this superficiality can be disturbing. Aesthetics is "the power of provocative surfaces," says one critic. It "speaks to the eye's mind, overshad-

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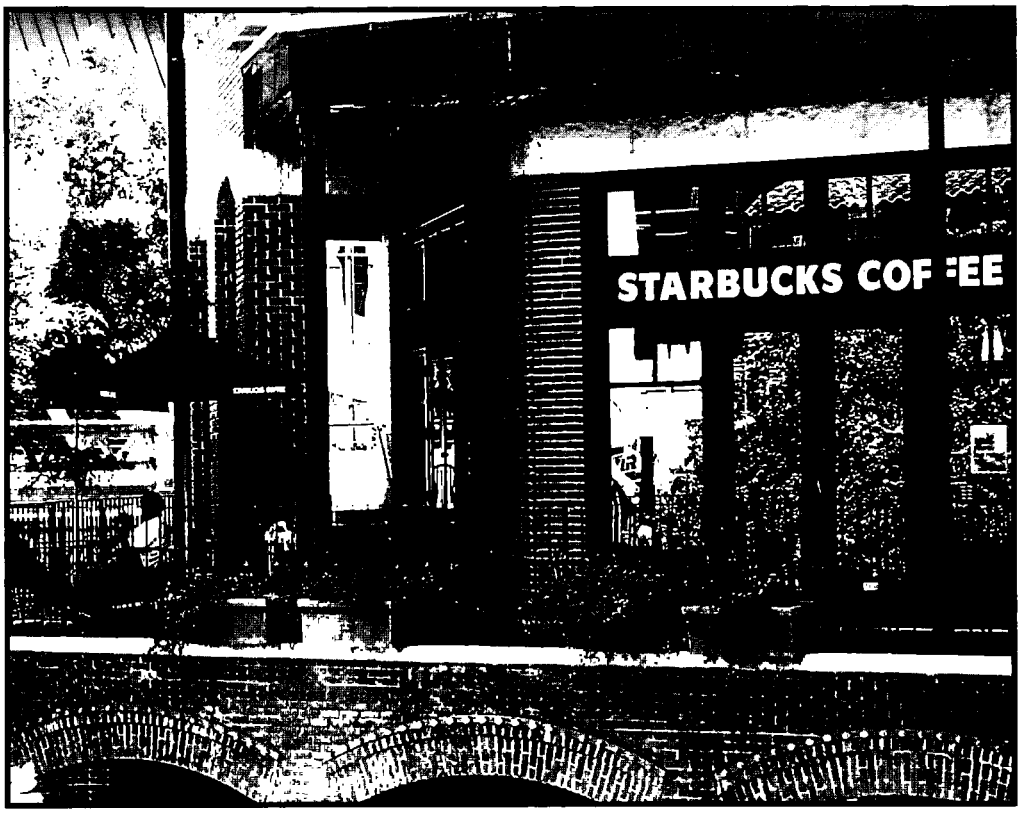

COURTESY OF STARBUCKS COFFEE COMPANY

Every Starbucks store is carefully designed to enhance the quality of everything the customers see, touch, hear, smell or taste.

owing matters of quality or substance." In the marketplace, according to this critique, we are seduced by style – enticed to pay more for less because the item in question comes in a pretty package. Indeed, many a curmudgeonly commentator has groused about the high price of Starbucks' double latte.

Yet aesthetics has a force of its own. We don't need cellular phones with silvery mirror finishes – but Nokia was smart enough to realize we might want (and pay more for) them. Aesthetic value is real value, and producers win customers by selling it. "In a world in which most consumers have their basic needs satisfied, value is easily provided by satisfying customers' experiential needs – their aesthetic needs," write Bernd Schmitt and Alex Simonson in the 1997 book, *Marketing Aesthetics.* Appearance counts – not just in traditional beauty industries like fashion, cosmetics or entertainment, and not just in the luxury market.

For example, in a market dominated by the extremely efficient (and much larger)

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Wal-Mart, Target discount stores can't compete purely on price. Innovative design is therefore central to the chain's strategy. "What we've staked out is we're going to be the trend leader," says David Gerton, Target's buyer for home decor. In February 1999, Gerton's department made a splash with a new line of housewares – some 250 items developed by the postmodernist architect-designer Michael Graves, whose $150 Alessi tea kettle was a symbol of 1980's extravagance.

Graves is well known among style aficionados. But his name means nothing to most of Target's middle-American shoppers, who are not in the market for tea kettles that cost more than VCRs. "It's the designs that sell the product, not whose name is on them," says Gerton. The playful novelty of the Michael Graves housewares has indeed captured customers. His toaster quickly became Target's most popular model, even though it runs $39.99, the top of the store's price range.

Graves' patio furniture has similarly commanded a premium price of $479, versus $400 for the previously top-priced set. Yet since its introduction, outdoor furniture sales are up 30 percent. Graves' picture frames, vases, clocks, and other gifts are outselling the chain's other gift products.

Aesthetics obviously involves beauty, but what we mean by beauty is itself fraught with ambiguity. People perceive some things as beautiful without regard to culture or context – symmetrical faces, smooth surfaces, specific color combinations. Along with this biologically based perception, there is a more contextual aesthetic sense. Something that looks novel may be interesting, or something familiar comforting, without regard to its beauty in some ideal sense. The Michael Graves toaster is cute – rounded and friendly looking – but it hardly represents enduring beauty. Its aesthetic appeal lies largely in its whimsical cheerfulness.

Some designs attract through emotional associations, whether personal or cultural. We enjoy some aesthetic elements more over time, as we develop a taste for them or explore more of their pattern and depth. Some styles draw power from allusion or wit. Aesthetics is not an absolute. It is a discovery process – a search through trial and error, experimentation and response, for sensory elements that move or delight. That process is open-ended and competitive, and one in which standards are subjective.

WHY THE AESTHETIC ECONOMY?

In their book, Schmitt and Simonson invoke the insights of psychologist Abraham Maslow to explain the growing importance of aesthetics in economic competition. Maslow's famous "hierarchy of needs" asserts that human beings satisfy basic needs, such as food and shelter, before moving on to less essential items. "Experiential and aesthetic needs are higher-order needs, which individuals seek only when basic needs have been satisfied," they conclude.

In all but the most extreme cases, however, the Maslovian model is wrong. We do not wait for aesthetics until we have full stomachs and watertight roofs. Given a modicum of stability and sustenance, human beings demand and create beauty in ritual, personal adornment and everyday objects. Five thousand years ago, Stone Age weavers living in Swiss swamps were working intricate, multicolored patterns into their textiles and using fruit pits to create beaded cloth. There was nothing utilitarian about this work, nothing that suggests a society focused only on lower-order needs. Even in the most difficult of circumstances, merely practical products do not suffice.

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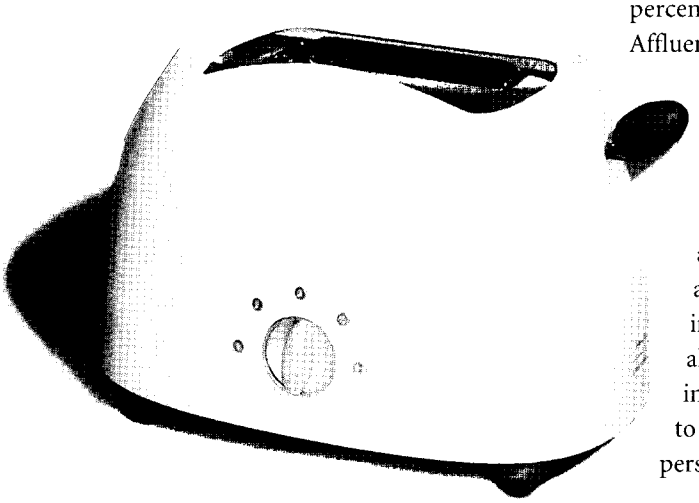

COURTESY OF TARGET STORES

The Michael Graves toaster is cute – rounded and friendly looking – but it hardly represents enduring beauty. Its aesthetic appeal lies in its whimsical cheerfulness.

With its emphasis on shifting relative prices, microeconomics is a better guide than Maslow to understanding the increasing value of aesthetics. As individuals or societies grow richer, they can consume more of virtually everything, including aesthetics. The marginal utility of some goods, such as food and basic shelter, is high initially but drops off faster than the marginal utility of other attributes, such as aesthetic quality. So we are increasingly willing to trade additional increments of basic goods for more aesthetic experiences.

The basics also come to include more aesthetic components. Clothing becomes decorative. Favored foods evolve from basic carbos and fat, to enticing flavors and elaborate dining experiences. Shelter expands to encompass architecture and interior design. Rich societies and rich individuals devote a greater percentage of their income to aesthetics. Affluence, therefore, is a major reason for the growth of the aesthetic economy.

At the same time tastes have changed, increasing the demand for aesthetic variety. To understand this change, we must first consider what aesthetics does for consumers. It generates pleasure, of course, which we can imagine as pure consumption. But it also makes social signaling and screening easier. Sensory cues tell us what to expect about a product, place or person. Thus, aesthetics can indicate class, attitude – even ideology.

Commercial brands use aesthetics to build identity, and so do individuals. A college student recounts her transition from preppy to punk: "I cut my hair very short and wore black clothes constantly. Wearing black made it easy to spot my friends and be spotted by them. While I was rebelling against society in general, being the nonconformist in that sense, I was also conforming with the smaller group of people that became my friends."

There is always a tension between the comforts of conformity and the desire for variety. To keep signals meaningful, we need aesthetic stability. But too much stability is boring. The interplay between conformity and variety is what creates fashion.

Adopting well-recognized new styles lets consumers (or organizations) enjoy novelty while still sticking with the mainstream or

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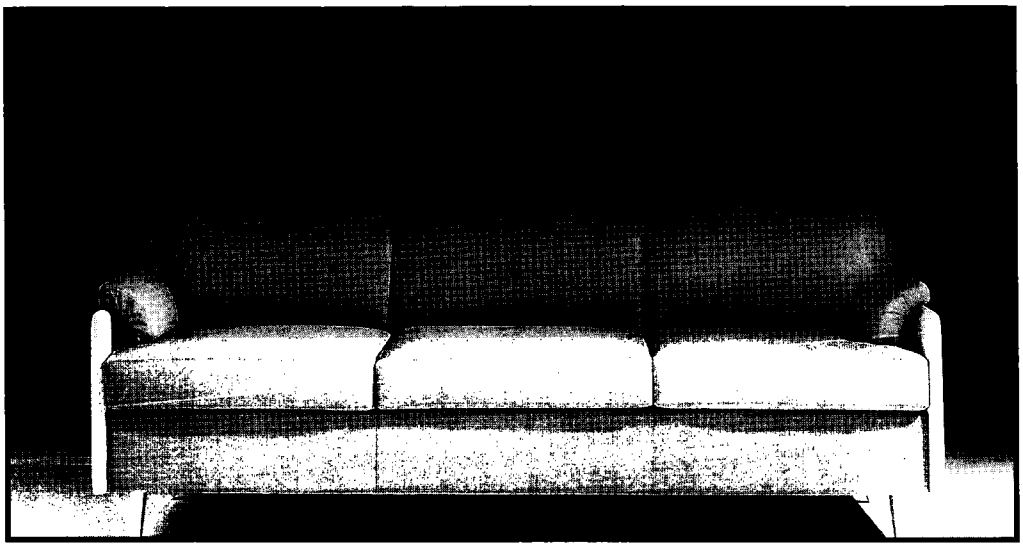

Jhane Barnes employs two mathematicians to create algorithms that embed her textile-design concepts in software.

with their preferred subgroups.

The dynamic of this interaction can change, as tastes shift between conformity and novelty or between group identity and personal expression. Earlier in the century, both businesses and social critics like Vance Packard imagined aesthetics as something imposed on consumers to manipulate them. From Paris fashion dictates to annual automobile model changes, the notion was that central authorities would decree hemlines and fin sizes – and that consumers, fearful of failing to live up to social expectations, would accept them. This plan didn't always work, of course: Some styles were complete flops. But it captured something true about what consumers wanted from mass-market aesthetics: the security not only of looking good, but of fitting in.

Over the past several decades, Western consumers have become more assertive and more interested in self-expression. (For what it's worth, I'm inclined to attribute the trend to the confidence inspired by greater education and multiple generations of middle-class living.) The result is a demand for what the Designers Society's Dziersk calls "individualized objects – more interchangeable artifacts that can be combined to represent a personality." Designers can no longer afford to imagine that they're dictating the perfectly controlled environment. Instead, their task is to develop components that consumers will rearrange in unpredictable, often highly personal ways. Although designers have less control over how their creations will be used, there is more demand for their work since a few standardized styles aren't enough to satisfy consumers.

Meanwhile, a profusion of subcultures,

COURTESY OF JHANE BARNES

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often marked by distinctive styles, has increased everyone's daily encounters with a broad range of aesthetics, thereby heightening awareness of design. Consumers and designers have more sources from which to pick and choose elements, increasing the potential supply of aesthetics.

One result is that styles once fraught with symbolism – blond hair on black women, earrings on men, crosses, and the like – start to lose their meanings. My propensity for royal blue fingernail polish says nothing about "transgression"; I just like the color. Aesthetics becomes less reliable (or at least less stable) as a social signal, even as its consumption increases.

THE TECHNOLOGICAL EDGE

On the supply side, the cost of producing aesthetic content is dropping dramatically, thereby increasing availability, raising standards and undermining the accuracy of income statistics. In the 19th century, synthetic dyes and chromo-printing drove down the cost of richly colored clothes and fancy paper goods, making them everyday objects. Working-class people could emulate the general styles – if not the full-blown luxury – formerly reserved for the wealthy. Today something similar is happening, mostly thanks to the falling price of computing power.

Graphic design once required the services of a specialist. Now, basic graphic elements come embedded in software for word processing, presentation slides and Web pages. Even cultural slugs with no taste can run decent-looking Web sites or publish passably attractive pamphlets – the know-how comes on a disk. What was once an unarticulated knack or a carefully honed professional skill has become an off-the-shelf product. The result is a higher standard of aesthetics in personal and business communications. While attractive presentation may no longer indicate respectability, ignoring aesthetics does send a negative signal – a disregard for the sensibilities of the audience.

Sensing all this, Kinko's has launched a $40 million marketing effort to get customers to use its services to meet those rising standards. "A napkin is not a 'leave behind,'" says a billboard, while another warns that "hand shadows don't count as 'overhead projections.'" A TV commercial shows a young man who convinces his girlfriend to marry him by using sharp-looking graphs that chart his increasing love and projected earnings. "I like what you've done here, Craig," she says. Kinko's message: "Sometimes it's not just what you say, but how you say it."

This trend has its dissenters, notably Scott McNealy, chairman of Sun Microsystems, who banned Microsoft Powerpoint presentation software as a waste of employees' time and intranet bandwidth. He wants handwritten slides instead. But audiences and presenters still demand aesthetics, and there are technological ways around McNealy's decree. After I wrote about it in *Forbes*, a reader responded: "I work for the Java Centers, a consulting organization within Sun, and we do zillions of presentations. We've handled this prohibition by doing our slides in Blueprint or Comic Sans, two fonts which look like hand lettering."

For producers, technological advances have changed both the process of aesthetic creation and the constraints it faces. The cosmetic surgery boom is partly a product of computer-controlled lasers and endoscopes that require only tiny incisions. For industrial designers, computer-aided design systems have made the process of creating renderings and building models much faster and easier, allowing many more possibilities to be explored. The same is true for graphic designers,

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architects and interior designers, who use slightly different tools. In some cases, the new technology enables aesthetic combinations that would have been impossible without computer assistance; Frank Gehry's curve-fitting architecture and George Lucas's special effects are the most prominent examples.

Jhane Barnes employs two mathematicians as full-time consultants to create algorithms that embed her textile-design concepts in software. She literally couldn't create some of the patterns without the computer assistance – they are too complex to graph or to remember. Others would require a week of tedious charting to do what she now manages in an hour. These specialized software tools have given Barnes many more design options, and much more time to explore them.

"The design process is much faster," Barnes notes. "So that means my collection can be larger, and that means business can grow. Also, I'm more prolific. That means I can be a better designer, because I can throw away things that didn't take so long to design and say, 'Oh, I can do another one in a short amount of time, so let me just make it better.'"

But coming up with a new season's collection takes as long as it ever did: The computer just allows more iterations. "If I know I have a month to finish fall," Barnes says, "even though with the computer I could finish it in a week and take a three-week vacation, I'm having too much fun – I take the whole month. So the line is better than if I had to do it the long way."

Just as software enables Barnes and others to create designs that were not previously possible, computing power is making the internal workings of many products smaller and lighter. Mechanical parts are replaced by ever-shrinking (and ever-cheaper) electronics. This trend both increases the importance of so-called provocative surfaces and makes more sorts of surfaces possible.

"Products that formerly had their shape, weight and bulk defined by the mechanisms that filled them (viz., telephone shells once had to accommodate bells, gears, dials and wiring) have now become 'dematerialized,'" writes sociologist Harvey Molotch. "What is necessary inside is small and light compared to what can go on the outside. Shape can follow whimsy, mimic icons, and enhance visual and tactile experience." Function thus implies no particular form.

If the Consumer Price Index can't recognize the longer life of tires or the existence of cellular phones, it's certainly not going to notice the value of better-looking memos.

AESTHETIC CONFLICT

The aesthetic economy presents the same sorts of problems of disruption and measurement that other economic changes have created. Like other trends that reward personal qualities over physical strength, it may shift the relative value of male and female employment in a way that favors women. (This is not a foregone conclusion, however; industrial design, for example, is an overwhelmingly male field.) It also favors certain regions, such

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as Scandinavia and Southern California, over others. It requires people in many fields to invest in learning new skills.

The value of aesthetics, though real to consumers, is not easily measured. Just as it is difficult to measure the productivity of services, aesthetics may be better without being more profitable. If your competitors invest in better graphics, prettier stores or nicer food presentation, just staying even can require spending more on aesthetics, with no increased profits to show for it. That can skew economic statistics: If the Consumer Price Index can't recognize the longer life of tires or the existence of cellular phones, it's certainly not going to notice the value of better-looking memos.

On a more personal level, the competition to look good revealed by the cosmetic surgery statistics can be a real pain – even if no actual cutting of flesh is involved. As producers, many of us would prefer to look like slobs. And even with software tools to counteract the temptation to be sloppy, developing design skills takes time away from things we might rather do. Mere surfaces, we tell ourselves out of both conviction and convenience, are not real.

As consumers, however, we benefit from the increase in aesthetic standards, and we demand more. So the race continues, and we get to enjoy a more attractive world, even as social critics denounce the beauty myth for creating it. The Puritan heritage, with its distrust of decoration and visual symbolism, remains an important strain in our culture and intellectual discourse. The value consumers attach to aesthetics remains, to many commentators, a sign of folly or deception.

As the importance of aesthetics rises, people develop passionate attachments to particular aesthetic styles, or to aesthetic quality in general. The result is increasing political conflict between aesthetics and other values, and between different aesthetic visions.

Over the past 20 years, aesthetic regulation has become a much more common element of land-use controls. Zoning laws and environmental-impact statements have been joined by architectural review procedures. In some cases, these processes are limited to historic preservation. But increasingly they seek to make purely aesthetic standards, which are by nature highly subjective, a part of the regulatory process. It is not enough to control environmental spillovers, as Victoria Tschinkel, Florida's Secretary of Natural Resources, said in the 1980's: "We have to decide, as Floridians, is this going to be a classy place or not?"

Some aesthetic regulations seek to avoid "incongruous" construction, while others forbid "monotony." Some specify particular architectural styles, materials or colors. Among other requirements, Portland, Oregon now limits the width of garages that face the street in new houses and specifies what percentage of the façade must be windows and doors. When builders and real estate agents protested that the rules would make houses too expensive and harder to site – especially on urban "infill" lots – officials countered that aesthetics considerations were more important than economic or logistical ones.

"Nearly every day, I or someone in my office hears a complaint from a citizen about the poor quality of design of new construction.... I've heard complaints for so long and from so many, that I simply cannot support your request that we do nothing about this issue," City Commissioner Charlie Hales wrote to the Portland Metropolitan Association of Realtors. "So I want to encourage you and your members and your colleagues in the development industry to propose something – anything – that will put a

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Frank Gehry's Art Center for Bard College

The very power of aesthetics encourages people to become absolutists – to insist that other people's stylistic choices constitute a form of pollution.

stop to the ugly and stupid houses that we see going up."

Writing about the issue, Kelly Ross, director of government affairs for the homebuilders, noted that Hales' own custom home wouldn't be allowed under the new standards because its two-car garage occupies more than 40 percent of the front facade. Ross' point does more than suggest hypocrisy. It indicates something important about the cost of design controls: They limit the aesthetic customization that people value, and they preclude experimentation. Indeed, their whole point is often to avoid stylistic variation. Novelty commands attention, which is why it has aesthetic value over and above the effects of the particular design. But that attention can be negative as well as positive.

Frank Gehry's innovative architecture, for instance, is highly polarizing. His forms are unlike any previously possible, and whether people will grow to love them or hate them over time remains an open question – a matter for discovery and experimentation. His fans want to hire him to do more buildings, while his detractors want, at the very least, to make sure those buildings stay hidden from view.

When Bard College in Annandale-on-Hudson, NY hired Gehry to design a $26 mil-

WHIT PRESTON

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lion performing arts center, neighbors raised a ruckus with the local planning board. The stainless steel structure, they claimed, would destroy the visual harmony of the local landscape, with its woods and historic buildings. Bard unsuccessfully argued that the building would barely be visible from outside the campus. But under pressure from the public and the planning board, the school eventually agreed to relocate the center. It will move the building farther inside the campus, away from existing arts buildings, at an additional cost of $10 million.

Beauty is in the eye of the beholder, and it is not the only thing that individuals value. But the very power of aesthetics encourages people to become absolutists – to insist that other people's stylistic choices, or their tradeoffs between aesthetics and other values, can constitute a form of pollution. Here, Nobel Prize winner Ronald Coase's theory of social costs can be a helpful guide to policy. Instead of assuming that the source of the "pollution" is the party that should be responsible for mitigating it, Coase encourages us to look at the relative costs to the two parties of avoiding the harm. A homeowner derives large benefits from a design that satisfies his or her preferences, while the cost of changing that design is high, both in dollars and in lost utility. The person complaining about ugly and stupid houses, by contrast, can generally avoid aesthetic harms simply by not looking at the designs. And since we tend not to notice things that have been around for a while, that avoidance cost goes down over time.

This analysis suggests that in aesthetic matters, the norm should make those offended by their neighbors' choices responsible for dealing with the problems – by screening themselves, by paying their neighbors to remove the offensive features or by simply averting their eyes. This approach not only minimizes the costs of getting along, it preserves the aesthetic discovery process. And it avoids the absurd implications of extending the principles of aesthetic regulation – a world with fashion police, approved styles for memos and mandatory plastic surgery.

The temptation to exercise political coercion to force one's aesthetic opinions on others, can be overwhelming in the face of what seems ugly or inappropriate: How dare that person have such bad taste! Perhaps we need an aesthetic equivalent (or interpretation) of the First Amendment to overcome this temptation. Such questions, unfamiliar as they are, will become increasingly prominent as the economy becomes more and more devoted to producing aesthetic values. Instead of the classical proposition *de gustibus non disputandem est*, we may find ourselves in a world where matters of taste are our most intractable disputes. ▣

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SPEED DOESN'T KILL

Requiem for the 55-mph Speed Limit

BY STEPHEN MOORE

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One of the Republican Congress's first and most popular initiatives back in 1995 was to repeal the 55-mile-per-hour speed limit. And at the time, the highway-safety lobby made apocalyptic predictions about the coming carnage on the roads. On *The Today Show*, Judith Stone, president of Advocates for Highway and Auto Safety, predicted "6,400 added highway fatalities a year and millions of more injuries."

We now have three full years of data with which to assess the validity of those forecasts. In 1998, there were 41,471 deaths on the nation's highways – 346 fewer than in 1995. Deaths per vehicle-mile traveled have fallen dramatically. Indeed, if the fatality rate had simply remained as high in 1998 as it had been in 1995, 2,000 more travelers would have died.

The news on vehicle injuries is even more encouraging. The injury rate per 100 million vehicle-miles traveled fell from 143 in 1995 to 122 in 1998 – the lowest injury rate ever recorded. If the this rate had been as high in 1998 as it had been in 1995, some 20,000 more people would have been injured on the roads.

Advocates of the double-nickel speed limit attribute the decline in injuries and fatalities to safer cars, arguing that if the 55-m.p.h. limit had remained in place the toll would have been yet lower.

Since the crash-worthiness of cars should not affect the probability of accidents, one way to control for other safety factors is to compare the number of crashes. That number did indeed rise between 1995 and 1997, but as a percentage of miles traveled there has been virtually no change.

The insurance industry begs to differ. Specifically, the Insurance Institute for Highway Safety released a study in December 1998 suggesting that deaths increased by 15 percent on roads with higher speed limits. But that study examined only a sample of the states that raised speed limits. Reworking the Institute's numbers with all states and all roads, we found that the fatality rates were only 1.5 percent higher in the states that increased the speed limit.

The more relevant measure, the fatality rate, actually fell in the states with the higher speed limits. And the year after the Insurance Institute's report was released, 8 of the 12 states with higher speed limits in its analysis had declines in traffic fatalities. On some unsafe roads in some areas of the country, higher speed limits have been associated with more deaths and injuries. Texas, for instance, raised the speed limit above 55 m.p.h. on thousands of miles of narrow, undivided two-lane roads, and crashes soared 45 percent. But such cases argue for lowering speed limits on dangerous roads – not for lowering speed limits nationwide.

The bottom line: Drive 65 and thrive

In sum, all of the evidence thus far indicates that repealing the federal speed limit has caused minimal, if any, loss of life. Meanwhile, Americans have saved billions of hours spent on the road. This helps to explain

LEFT: PETER GRIDLEY/FPG INTERNATIONAL; RIGHT: DENNIS BRACK/BLACK STAR

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why most American drivers supported higher speed limits in 1995 – and still support them today.

THE FAILED LEGACY OF THE DOUBLE NICKEL

In March 1974, Congress established the national 55-m.p.h. speed limit as a response to the Arab oil embargo. The intent was not to save lives, but to force drivers to get the better mileage available at slower speeds – and thereby reduce the nation's dependence on imported fuel. Though many states, particularly those in the sparsely populated West, objected to this Federal intrusion, Congress enforced the mandate by withholding Federal highway money to states that failed to crack down on speeders. Noncompliance was eventually defined as a state's having more than 50 percent of the traffic on its Interstate highways traveling more than 55 m.p.h. for two successive years.

In the mid-1980's Arizona, Maryland, New Hampshire, Vermont and Wyoming were all found wanting in the enforcement department. They received warnings from Uncle Sam or were penalized with a loss of Federal highway funds.

But as a fuel-saving measure, the 55-m.p.h. speed limit was a bust, reducing fuel consumption by no more than 1 percent. It is also worth noting that the National Research Council has since estimated that raising the speed limit to 65 would increase oil consumption by less than two-tenths of 1 percent.

Congress did relax the double nickel on rural Interstates in 1987. But the 1974 law was only fully repealed in December 1995. And it is worth emphasizing that by repealing the law, Congress did not raise speed limits in the states. It merely allowed states to raise speed limits as they saw fit.

One of the most compelling arguments made by members of Congress in favor of repealing the federal speed limit law was that it ignored geographic diversity. Southern and Western states complained that although a 55-m.p.h. requirement might be justified in the densely populated states of the Northeast, it made little sense in states like Texas, Utah and Wyoming with wide-open spaces and very little traffic congestion.

DID THE DOUBLE NICKEL SAVE LIVES?

Although the original rationale for higher speed limits was energy conservation, this justification lost its appeal in the collapse of fuel prices in the mid-1980's. Hence, the "Stay Alive at 55" campaign was born.

There was certainly strong circumstantial evidence that the lower speed limits were reducing traffic fatalities. The first year after the limits were in place, highway deaths plunged by 15 percent. But there are many reasons to believe that the relationship between the reduction in traffic fatalities in 1974 and the lowering of speed limits was spurious.

First, higher gasoline prices and sporadic shortages reduced driving. And the decline in miles traveled was particularly substantial during discretionary driving periods – weekends and holidays – when the rate of traffic accidents is higher than average.

Moreover, the cut in traffic fatalities in 1974 actually predated the raising of the Federal speed limit. Milton Copulos of the Heritage Foundation noted that "In October 1973, when the OPEC embargo was announced, somewhat more than 4.4 people were killed on the nation's highways per 100

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million miles traveled. By February 1974, one month before the National Maximum Speed Law was enacted, the fatality rate had dropped to slightly more than 3 per 100 million miles traveled. Over the next nine months, with the newly instituted speed limit, the fatality rate rose to close to 4 persons per 100 million miles traveled by November 1974, then dropped somewhat in December. The fatality rate in December 1974 under the National Maximum Speed Law was nearly a third higher than it was in December 1973 without it."

No fuel = no traffic accidents

IVAN MASSAR/BLACK STAR

If lowering the speed limit was responsible for the decline in fatalities, then the fatality rate should have risen gradually after 1974, as average speeds crept back up. By 1982 the average speed on the highways had risen from 57 to 59 m.p.h., but the fatality rate fell by more than 25 percent from 1974 to 1984.

The fact is, the decline in fatalities in the 1970's was a continuation of a long-term trend begun three-quarters of a century ago. Since 1922, the highway fatality rate has fallen by 3 percent annually. And in just the past two decades, highway death rates have fallen by about half.

There are several reasons why driving has become safer, even as speeds have risen. First and most important, cars are more reliable machines. From 1920 through the end of the 1940's, more than one-third of serious accidents were a result of equipment failure – usually tires, brakes or steering. The modern safety features of autos – safety glass, rigid passenger cages, disk brakes, seat belts and so forth – have dramatically reduced fatalities from crashes. Second, the roads and highways are wider, better maintained and better engineered, with improved surfaces and better guardrail systems. And finally, states have gotten tough on drunk and reckless drivers, who are a major cause of accidents.

THE BOGUS 6,400 DEATHS

Although there is little evidence that the 1974 Federal speed limit law saved lives, the proposal to let states raise speed limits was met with predictions of blood on the streets. The major opponents of higher speed limits were the consumer advocacy groups led by Ralph Nader and Joan Claybrook, the Clinton Administration's Department of Transportation and the insurance industry.

David F. Snyder, the assistant general counsel of the American Insurance Association, warned Congress and the public that "higher speed limits would cause 6,400 additional highway deaths a year and add $20 billion a year in costs to taxpayers and insurance policyholders." As noted above, the 6,400-death figure proved attractive fodder for newspaper and television stories.

When pressed on where they got the 6,400-deaths estimate, the speed-control lobby said the number came from the

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National Highway Traffic Safety Administration. But in a memo on the subject, the Agency explained that "the figure is an example of the magnitude of our highway safety problem – if we saw a 30 percent increase in fatalities." The agency then conceded that it could not prove scientifically that higher speed limits would cause a 30 percent increase in deaths.

Uncle Sam apparently could, however, ignore contrary scientific evidence. In 1992 the Federal Highway Administration published the results of a five-year study of 100 sites in 22 states, concluding that "raising the posted speed limits did not increase speeds or accidents." The research found that drivers effectively set their own speeds on the basis of what they regarded as a safe pace, regardless of the posted limits.

There are real studies concluding that higher speeds do lead to increased highway accidents and deaths. But even NHTSA, which strongly opposed repeal of the 55-m.p.h. speed limit, claims only 350 more fatalities annually from higher speed limits.

IS DRIVING MORE DANGEROUS IN STATES WITH HIGH SPEED LIMITS?

Comparing the 16 states that did not raise their speed limits after 1995 with the 34 that did reveals a 12 percent difference in fatalities in the states with the 55-m.p.h. speed limit. But it is unclear whether there is any causal relationship here. Back when the national speed limit was 55 for all 50 states, those 34 states already had higher-than-average death rates.

Besides, there is plenty of evidence from time-series data that higher speed limits do not correspond with higher death rates. In Michigan, the highway death rate fell 5.9 percent the year after the highway speed limit was raised to 70 m.p.h. Indeed, the highway fatality rate rose in only 8 of the 34 high-speed states. All told, the fatality rate in the 34 states that raised the speed limit fell from 1995 to 1997.

Fatality rates changed less in the states that raised their limits – but not much less. Between 1995 and 1997 the rate fell by 5.6 percent in states that raised the speed limits, versus a 6.3 percent decline in the states that maintained the double nickel. Total fatalities rose by four-tenths of 1 percent in the states that raised the speed limit versus two-tenths of 1 percent in the states that maintained the 55-m.p.h. limit.

What about states that raised speed limits to 70 or above? Deaths were up 1 percent in those states, compared to a decrease of seven-tenths of 1 percent in the rest of the states. But this difference should be put in perspective. If the states with 70-m.p.h. limits had experienced fatality rates equal to the national average in 1997, there would have been 332 fewer deaths – one less for every three billion miles driven. Or, to put it another way, one life saved for every one million cross-country trips.

THE INSURANCE INDUSTRY STUDY

All of this good news about highway safety ought to be a source of embarrassment to the safety lobby. But the Insurance Institute for Highway Safety has beavered on, publishing two studies concluding that the death rate has surged on roads with higher speed limits. The first study, released in 1997, found a 12 percent increase in fatalities on Interstates and freeways with higher speed limits. The second, appearing in 1998, put the figure at 15 percent.

The Institute reports that 500 additional deaths were attributable to higher speed limits. And that number received wide publicity – more publicity, in fact, than the news that total highway deaths were declining.

But the 1997 study was methodologically

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flawed. First, by examining only the change in the death rate on roads with higher posted speed limits (rather than on all roads), the study overstates deaths caused by higher speed limits.

Why? Because one consequence of raising speed limits on highways is to draw traffic from the more dangerous secondary roads. In most states an increase in highway speed limits causes more deaths on the highways, but the number is more than offset by a decline in deaths on more dangerous back roads. In fact, the Insurance Institute asserts that fatality rates did not fall on roads where the speed limits were not raised. But this is an arithmetic impossibility. If the fatality rate rose on the roads with higher posted speed limits, and if the overall fatality rate fell in those states, then the fatality rate could not have fallen on all other roads.

Second, the study examined the fatalities in 1996 for 12 states with higher speed limits. However, 11 of those 12 states had lower fatality rates in 1997. Therefore, the results of the study do not hold up for the second year of higher limits.

Third, the study examined only 12 of the 16 states that raised their speed limits between December 1995 and March 1996. In the states excluded, the number of road deaths fell by 4 percent. So the result is simply a function of the sample chosen.

The same problems contaminate the Institute's 1998 study. For example, it excluded nine states with higher speed limits in 1995 and 1996. Of those nine, Illinois had the second-largest decline in fatality rate between 1995 and 1997, Iowa ranked fourth in largest overall decline and Maryland ranked sixth. In fact, of the states that raised the speed limit but were excluded from the 1998 study, the number of fatalities fell by 1.9 percent and the fatality rate fell by 5.9 percent.

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Crash dummies do not die in vain.

On balance, there is no basis in fact for the Insurance Institute's conclusion that repealing the Maximum Speed Law led to a 15 percent increase in fatalities. If there was any increase in deaths, it was probably one-tenth of that.

WHY SPEED DOESN'T KILL

There are several explanations for why higher speed limits do not correspond with more deaths. One is that speed isn't the core issue in highway safety. Writing in the 1985 *American Economic Review*, transportation economist Charles A. Lave of the University of California-Irvine wrote that there is "no statistically discernible relationship between the fatality rate and average speed, though there is a strong relationship to speed variance. When most cars are traveling at about the same speed, whether it is a high speed or a low one, the fatality rate will be low.... Variance kills, not speed."

Speed limits that are too low can be just as dangerous as speed limits that are too high. Eric Peters, a writer on automotive issues, explained in *The Wall Street Journal* that "sometimes higher speeds are safer because they reflect the normal flow of traffic – what highway engineers call the '85th percentile' speed. This is the speed most drivers will maintain on a given stretch of road under normal conditions. When speed limits are set

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artificially low, tailgating, weaving and speed variance (the problem of some cars traveling significantly faster than others) make roads less safe."

A second reason that higher speed limits have not caused more deaths is that average speeds traveled have only risen by about one to three m.p.h. on highways with higher speed limits since 1995. In other words, Americans were already traveling well over 55 miles per hour on highways before the speed limits were raised.

One effect of the 1974 speed limit was to create a nation of scofflaws. The double nickel was arguably the most disobeyed federal law in American history – or at least since Prohibition. The Department of Transportation estimates that about 70 percent of American drivers exceeded the 55-m.p.h. limit. And the National Motorists Association estimated that during the last year New York had a 55-m.p.h. speed limit, compliance was just 4 percent. Indeed, the law spawned whole new multi-million dollar industries in citizens' band radios and radar detectors.

To protest the Federal speed limit law, Montana imposed a $5 maximum penalty for speeding. Legend has it that after issuing a ticket for $5, troopers would caution drivers to hold on to the receipt, since it was good for the whole day.

One could argue that the limit itself was a hazard, encouraging drivers to spend too much effort looking for patrol cars and distracting the highway patrol from the task of enforcing more important laws. In fact, an association of highway state troopers passed a resolution against the Maximum Speed Law in 1988, noting that enforcing the 55-m.p.h. speed limit causes "the over-concentration of limited resources for the express purpose of attaining compliance rather than application of resources in a manner most effectively enhancing total highway safety."

HIGHER SPEED LIMITS AND INSURANCE COSTS

Another way to measure whether the roads are less safe than before the speed limits were raised is to examine automobile insurance claims and premiums. If there are more automobile accidents, that should be reflected in insurance costs. Yet contrary to the insurance industry's dire predictions, insurance costs have fallen – in some cases, dramatically. In 1996 and 1997 there were fewer accident claims per 100 cars insured and the size of the average claim was lower, suggesting less serious accidents.

According to a recent article in *The Wall Street Journal*, "automobile insurance premiums are coming down for the first time in more than 20 years for millions of car owners, as big insurers pass along some of the savings they've enjoyed from nearly five years of favorable experience."

The automobile insurance industry argued that higher speeds would lead to higher auto insurance rates. Yet both claims and premiums have declined – reversing a decade of higher costs. Collision claims were down 3.1 percent in 1997 and bodily injury claims fell by 4.7 percent in that year. In June 1998, State Farm, a mutual insurance company, announced that it would rebate $900 million to policyholders/shareholders. Another major auto insurer, Allstate, has also reported banner years for profits and lower costs since 1995.

HIGHER SPEED LIMITS: COSTS VS. BENEFITS

To beat this dead horse yet again, the evidence indicates that the increase in injuries and fatalities has been minuscule – certainly much smaller than the opponents had feared.

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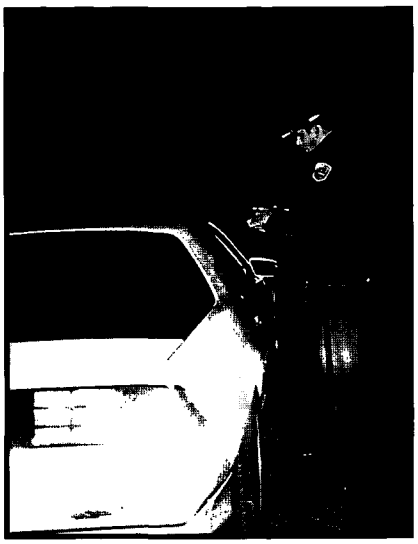
But a case could still be made that higher speed limits are not justified if they result in even a small increase. Indeed, some safety groups seem to suggest that the optimal speed limit policy is one with zero tolerance for reduced safety.

However the appropriate question to ask is not whether there are costs to higher speeds, but whether those costs are offset by personal and societal benefits. If that seems cold-blooded, play out a zero-tolerance strategy to its logical conclusion. The National Highway Traffic Safety Administration has found that when speed limits are above 40 m.p.h., death tolls are higher. So if a speed limit of 55 is better than 70, safety groups should be asked why a speed limit of 40 is not better than 55. The obvious answer is that there are large benefits to getting from here to there faster.



Hold onto that receipt: It's good for the whole day

NHTSA estimated that in 1996 there were "approximately 350 more Interstate fatalities than would have been expected based on historical trends – about 9 percent above expectations." NHTSA then calculated "the total economic cost of the 350 additional fatalities and the associated injuries and crashes at more than $820 million." For the reasons detailed earlier, this 350-death figure is improbably high, but for the sake of argument assume it is correct. Do those costs exceed the benefits of faster transportation?

To calculate the benefits from higher speed limits, one must estimate the economic value of the time saved. In 1985 the Transportation Research Board estimated that the 55-m.p.h. speed limit caused Americans to spend 1 billion more hours in their cars than necessary. If a person's time is worth his or her wage rate, then the 55-m.p.h. Federal speed limit cost America between $20 billion and $30 billion a year. Thus, the average annual societal benefits of raising the speed limits is 20 to 35 times higher than the $820 million cost estimated by the Government.

By any rational calculation, then, the double nickel is less than the optimal speed limit. Unless, of course, one assigns an infinite value to life. It is worth noting, though, that many who claim that no loss of life should be tolerated in the name of higher speed limits also favor Federal fuel economy standards that lead to lower vehicle weight – and to more traffic fatalities.

THE FINAL LAP

Americans have not responded to higher speed limits by converting the highways into training grounds for the Indy 500. With a few exceptions – notably, rural highways in Texas – average highway speeds have not risen to dangerous levels.

"The main issue for our members was simply having the right to drive at safe speeds legally and not having to worry constantly about getting pulled over," insists Jim Baxter, a spokesman for the National Motorists Association.

My educated guess is that most American drivers would agree. M

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the THIRD WAY

"The Asian Miracle is over," proclaimed Singapore's senior minister, Lee Kwan Yew, at the 1999 World Economic Conference in Davos, Switzerland. While he foresaw the resumption of economic growth, he did not expect a return to the extraordinary rates that made the East Asian Tigers the wonder of the world until the 1997-98 financial crisis.

Just so. Though many Asian economies have showed signs of recovery since Davos, evidence is accumulating to support Lee Kwan Yew's view of the region's long-term prospects. The Asia-Pacific Economic Cooperation group recently scaled back its 15-year growth forecasts for the Southeast Asian economies to 5.5 percent per year – a sharp drop from the pre-crisis average of 7.5 percent.

The financial crisis and the slowdown in growth are transforming the political, economic and social prospects of the region. Take Indonesia (please... as the Australians might say). If the world's fourth-most-populous country had managed to maintain the 8.5 percent growth rate it achieved in the early 1990's through the next decade, per capita

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gross domestic product, less than $600 in 1989, would have reached about $4,000 in 2010. Now, even if Indonesia grows at the 5.5 percent average predicted for Southeast Asia, per capita GDP won't make it to $1,000 by 2010.

Many observers believe that China's growth prospects have also significantly worsened. Beijing claimed that China's growth in 1997-98 was 7.4 percent, within bragging distance of the 8 percent target. However, there is substantial evidence that China's growth has since decelerated. In light of industrial over-capacity, a sharp slowdown in direct foreign investment, a deceleration in the growth of Chinese exports (from 21 percent in 1997 to just 0.5 percent in 1998) and the well-publicized problems of the Chinese banking system, a pronounced slowdown appears inevitable.

The implications are ominous. Indonesia, the hinge of United States policy in Southeast Asia and the most important factor in the emergence of the Association of South East Asian Nations as a significant force for regional stabilization, has fallen into conflict and disarray that has already cost thousands of lives. A slowing of economic growth in China could result in mass political disaffection with unpredictable consequences.

Throughout the region, social tensions must be expected to rise as hopes for higher living standards dim. In particular, the growth of the middle class – generally viewed as the foundation for democracy and a peaceful foreign policy – has received a sharp setback. And with civil or international wars looming from Korea to Kashmir, any increase in stress poses grave challenges to American foreign policy.

Asia's immediate problems point to more deep-seated flaws in the model of development that the continent has followed. Advanced economies like Japan and South Korea have been affected, but so have countries near the bottom of the development ladder, like China and Indonesia. Countries that do not regulate international capital flows have suffered. But neither Malaysia's emergency capital controls nor the more elaborate Chinese currency controls have protected these economies from dimming long-term growth prospects.

Indeed, the economies that, so far, have escaped with the least difficulties have been Australia, which never followed the export-led growth strategies that dominated Asian planning in recent decades, and India and the Philippines, which never fully shifted to the export model. Taiwan, which helped to originate the core model, has always enjoyed a more diversified corporate and financial structure than other export-oriented

How to reach beyond export-led growth

to ECONOMIC DEVELOPMENT

By Walter Russell Mead

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countries.

And if export-led growth is no longer the cure for what ails developing countries, other parts of the world are going to have to rethink their policies. NAFTA and the Caribbean Basin Initiative both are grounded on the belief that export growth is the surest, quickest way for emerging economies like Mexico to trigger modernization. And reform efforts in Africa and Eastern Europe are also tied to the efficacy of export-oriented growth.

The recovery of Europe and Japan was seen as the only way to stop Communism.

THE DEVELOPMENT OF DEVELOPMENT

The modern era of development begins with the end of the Second World War, when the world faced two basic economic challenges. On the one hand, the leading European states and Japan had been devastated by the war and needed repair. On the other, states emerging from the ruins of the European colonial empires were eager to emerge from poverty.

The United States, then as now the most important economic actor in the world system, placed a high priority on addressing both demands. The recovery of Europe and Japan and economic growth in the rest of the world were seen as necessary both for the long-term health of the American economy – and as the only way to prevent Communist advances during the cold war.

In western Europe, Japan and what would soon become known as the third world, the economic problem was seen as a dollar shortage. The United States was the world's principle supplier of food, consumer goods and capital goods; access to dollars was thus crucial for countries that needed to prop up their living standards or to invest for the future.

The international financial architecture that emerged was adopted for the double mission of helping advanced war-devastated economies and newly independent economies grow in the teeth of the dollar shortage. Indeed, the formal name of the World Bank – the International Bank for Reconstruction and Development – still commemorates this dual purpose. In broad terms, the strategy was to pursue Keynesian full employment and, when necessary, to ante up hard currency to cover balance of payment deficits.

Currency flows were tightly restricted in order to deter capital flight. Governments limited imports, channeling dollar reserves to priority purposes and limiting the uses for which individuals or companies could access dollars – even those generated by their own exports. At the same time, the ability of American investors to make portfolio investments around the world was curtailed. And with some reason: In the postwar climate, American investors could have bought up virtually the entire corporate sectors of the war-ravaged economies as well as the resources of the developing world at fire-sale prices.

By the 1950's Europe and Japan had largely recovered from the war, and they gradually eased capital controls. But the developing countries faced more severe problems, and the common response was a range of development strategies assigned the rubric "import substitution."

Capital controls were maintained and

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scarce foreign currency was reserved for investments deemed likely to reduce dependence on imports. Steel-importing countries, for example, built steel mills with the idea that they could dispense with expensive imports and use the hard currency for other needs. Developing countries followed full-employment policies so that domestic demand would provide a ready market for the new industrial capacity. These policies were politically popular and often led to close alliances between political establishments and trade unions, which shared an interest in building state-supported or state-owned industrial showpieces.

The World Bank blessed import substitution, providing hard currency at attractive terms. And for many years, key developing economies made substantial progress. Brazil, for example, grew at 7.4 percent annually from 1950 through 1974. In the same period, India increased cement and steel production seventeen-fold. And Egypt built the Aswan Dam, bringing 18,000 square miles of land under cultivation.

Living standards improved, too. Between 1950 and 1975, median life expectancy rose 8.6 years in Brazil, 14.2 years in India and 15.3 years in Indonesia.

Despite successes like these, it had became apparent by the 1970's that import substitution had only limited value – and that this value decreased with time.

Building a national steel plant was all very well. But banning imports of foreign steel meant that consumers paid higher than world market prices for the critical material. And shielded from global competitive pressures, developing-country industries fell far behind in both technology and productivity. At the same time, the political links between privileged industrial groups, policy makers and bankers became closer – and, in many cases, corrupt.

Both the corruption and the inefficiency of the state-sponsored industrial sector gradually became more entrenched and was reinforced by the ties between organized labor, the state and the state-protected industrial sector. Wealthy individuals and companies became more skilled at evading capital controls and exploiting the windfalls created by the rationing of hard currency. By no coincidence, import substitution-based economies began to experience declining growth rates and rising inflation.

The price shocks of the 1970's sounded the death knell for industrialization based on import substitution. Oil prices put great pressure on energy-scarce economies. And because industries lacked access to both the technology and the capital to improve energy

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efficiency, state-organized enterprises had more difficulty bouncing back than their counterparts in more open economies.

The deregulation of international capital markets that accompanied the collapse of the Bretton Woods fixed-exchange rate regime meant that official lenders were increasingly hostile to the exchange rate controls and import substitution strategies. Heavy borrowing from commercial banks to sustain the import-substitution-as-usual pushed many developing countries deeply in the red, yet left them without capacity to service their new debt.

Older Americans can still remember the paper umbrellas, plastic novelties and cheap cameras with the "made in Japan" label.

TAKE TWO: REDEVELOPING REVELOPMENT

While Taiwan and Japan had both adopted some key features of import-substitution strategies, they addressed their capital shortages in a different way. Rather than building heavy industry to reduce the need for imports, both built labor-intensive industries that exported consumer goods. Textiles played a key role in this early industrialization. And older Americans can still remember the paper umbrellas, plastic novelties and cheap cameras with the "made in Japan" label.

In effect, Taiwan and Japan reprised the industrial revolution in Europe and the United States, in which technology first used in textiles and other light industries was gradually applied to capital-intensive heavy industry. And as policy makers reflected on these successes – as well as on the failure of import substitution – a new development model emerged.

Developing countries that focused on exports enjoyed greater access to capital than import-substitute economies. By selling goods in the United States, exporters earned dollars; reinvesting those savings in additional export-producing enterprises produced ever-larger streams of dollar revenue. At the same time, a shift away from Keynesian, pro-consumption policies increased domestic savings rates – thereby making more domestic capital available for investment.

Developing countries also learned to accept larger amounts of foreign direct investment and to channel this investment into export production. Export Processing Zones played a large role in the early stages; developing countries built infrastructures for importing, manufacturing and exporting goods. And they offered tax holidays, wage and regulatory concessions and the free import of components and materials for export production. The payoff came in both substantial export growth and increasing rates of technology transfer, as foreign investors sought to combine the advantages of cheap labor with those of high-tech production processes.

In most cases, the export-oriented model supplemented import substitution, but did not entirely replace it. Following Japan's lead, export-oriented economies continued to restrict the free importation of foreign goods – but through tariffs and quotas rather than the capital controls and outright prohibitions that marked the old system.

By the same token, the structure of corporate ownership and the financial system did

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not change much. With the exception of Taiwan, financial markets in export-oriented countries were similar to those of import-substitution economies. They did not serve as competitive financial intermediaries, allocating credit on the basis of prospective returns. Rather, they were instruments of state planning, channeling savings into target industries and companies. Complex ownership structures, marked by cross holdings and often linked to politically powerful families, insulated these economies from competitive market forces. Restrictions on foreign ownership insured that foreign capital would move primarily through the politically reliable banking system.

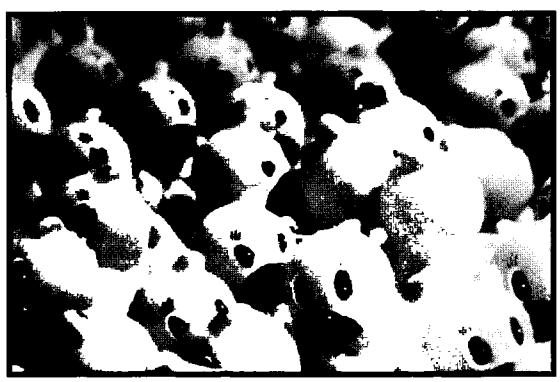
As with import substitution, export-oriented growth models yielded striking results in their early years. But their limitations became evident over the long haul. Like the import-substitute economies, the "developmental state" proved less successful at long-term guidance. Corrupt connections between business and political leaders warped the focus of policy. Meanwhile, growth itself made developing societies more difficult to run, with increasingly diverse interest groups demanding a place at the table.

DOUBLE BUBBLE TROUBLE

A combination of external factors posed challenges that ultimately proved too much for these societies to manage. The first was a growing mismatch between international financial architecture and the financial institutions of the export-oriented economies. Just as the end of fixed exchange rates and capital controls exposed the import substitution economies to international financial pressures they were ill equipped to withstand, financial liberalization in the 1990's outstripped the capabilities of export-oriented financial systems.

Initially, the post-Bretton Woods system served export-oriented economies relatively well. financial deregulation facilitated the transfers needed to accommodate trade and investment. Trade liberalization improved developing countries' access to markets for manufactured goods. And through the 1980's, little was asked in return.

Developing countries were allowed to maintain high import tariffs in what they deemed strategic industries, insuring that their champion exporters controlled profitable domestic markets. Moreover, they weren't pressed to open their domestic service



sectors to foreign investment.

But the easy times ended with the collapse of Cold War solidarity. The World Trade Organization agreement mandated increased foreign access to both goods and service markets in developing countries. And as international flows of funds increased, developing countries were pressed to ease capital controls and to allow foreign investors access to local stock markets.

Banking systems were also deregulated under international pressure, with the result that two financial regimes came to exist side by side in many economies. On the one hand, the old system of state-allocated credit continued, preserving the culture of cronyism. On the other, hot money poured into the

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market and was available for speculative investments.

An international economic regime that once supported the export-oriented approach to development while allowing developing countries to shelter their fragile financial systems was replaced by a more open system with greater opportunities. But the new regime came with greater risks and dangers. Simultaneously, export-oriented economies began to encounter problems of diminishing returns.

As more economies joined the export pack, competition tightened. A textile factory in the Philippines must now duel with counterparts in Bangladesh, China and Sri Lanka.

The first countries to embrace the export-oriented path had enjoyed markets for their products that were essentially infinite. Japan and Taiwan competed with producers in high wage, high tax, high regulation environments in Europe and North America. Thus, they were able to undercut their competitors on price while still achieving strong rates of return.

But as more economies joined the export pack, competition tightened. Today's textile manufacturer in the Philippines does not compete against companies in West Germany or Pennsylvania; those factories closed long ago. A factory in Manila must duel with counterparts in Bangladesh, China and Sri Lanka. And, surprise: returns from exports in this ferociously competitive environment are lower.

Advanced industrial economies deal with similar problems all the time. Shareholders and lenders quickly note a pattern of stagnant or falling profits and transfer capital from one company (or industry) to others. But the state-guided credit systems of many export-oriented economies react in just the opposite way, pumping ever more cash into troubled companies. This pattern was visible in countries as advanced as Japan and South Korea, but also in countries at much earlier stages of development like Indonesia, Maylasia and Thailand.

In financial systems designed for maximum obfuscation, news doesn't travel fast. Thus, even as returns eroded, investors (domestic and foreign) were mesmerized by GDP growth rates close to 10 percent and remained eager to buy into the game. Breakneck growth, they reasoned, would surely lead to greater demand for office space, shopping malls and upscale housing.

The newly deregulated international and local financial markets allowed investors to act on impulse and permitted inexperienced bankers who knew little about managing risk to lend billions of dollars in short-term money to optimistic and inexperienced borrowers. So Asia suffered not from one bubble but two: an industrial investment bubble caused by crony capitalism, and a real property/stock market bubble caused by investor herd behavior.

Japan was the first to experience the double bubble – and, as a capital-rich country, has been able to sustain economic activity, if

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not asset prices, through a combination of government stimulus and continued credit allocation. Lacking Japan's capital resources, the export-oriented economies on lower rungs of the development ladder suffered sharp economic contractions that, ironically, prepared the way for a more rapid recovery.

However, even as that tentative recovery takes hold, the problems of export-oriented growth will prevent a return to the good old days of the 1980's. We may well see Asian economies cycle to the brink of health and then relapse into recession until a new development model more suited to contemporary conditions can be adopted.

TAKE THREE: TOWARD THE NEW DEVELOPMENT MODEL

The world needs its third postwar development model. Developing countries can't revert – as some nostalgically propose – to import substitution. For while Malaysia's experience since 1997 has shown that targeted, short-term controls on capital are feasible, the wholesale capital controls that import substitution requires are simply impossible in the contemporary world.

Note, too, that the option of industrial autarky is no longer realistic. Industrial production is directed by an international division of labor, with components built in many countries and assembled in others. Even if it were practical, neither the rules of the World Trade Organization nor public opinion in the advanced industrial democracies would allow large developing economies to re-establish the restrictions on imports of an earlier era. What's more, the pace of technological change would mean that any country attempting to return to the import substitution path would quickly fall far behind countries integrated into the global system.

Developing countries thus must seek new ways to accomplish old objectives – to overcome the capital constraints that limit their growth potential and to find sustainable strategies for meeting their priorities in the prevailing international context. In brief, the new strategies will require (1) a shift from dependence on demand for manufactured exports; (2) reform that enables developing countries to use capital more efficiently while buffering national economies against international panics; (3) substantial increases in capital flows to developing economies.

Escape from dependence on manufacturing exports will be difficult, but it is the key to success. For everything points to a continuing deterioration in the terms of trade for manufactured goods.

The parallel to an earlier transition from agriculture is instructive. When the manufacturing economy first developed in the 19th century, mechanization, transportation and preservation technologies were opening new areas of the globe to the production of food and fibers. But the increases in agricultural productivity combined with vast expansion of land under cultivation led to a permanent fall in the price of agricultural commodities compared with other goods. Farm employment plummeted along with commodity prices; only well-capitalized and mechanized farms – along with those protected by tariffs and subsidies – were able to survive.

Something similar seems destined to happen to manufacturing. With the industrial revolution expanding into thickly populated districts of the developing world, manufacturing faces the sort of chronic over-capacity problems that agriculture has endured for most of the last century.

The demand for manufactured goods will surely grow more slowly than demand as a whole in the developed economies. As populations age, they spend more on medical care

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and less on stereos and sports cars. Slow population growth, or absolute population decline in countries like Italy and Japan, will also trim the demand for housing materials and home furnishings. And even where manufacturing demand remains strong – for computer components, for example – ferocious competition will squeeze returns.

To suggest that developing countries must move away from dependence on manufactured exports is not to suggest that they should abandon the export business – or that Western protectionism should be met with indifference. The export of manufactures will remain a major factor for many countries. By the same token, while it is no longer realistic to count on agriculture for much development oomph, many countries would benefit substantially from an end to the unconscionable restrictions on agricultural trade.

Growing domestic and regional demand (or, more broadly, South-South trade) will have to replace demand growth in the North as the major engine of future expansion in manufacturing. And, for better and worse, emerging market consumers do have a lot of catching up to do. China, for example, has barely one-half the television sets per capita as Germany. In the United States there are 40 personal computers per 100 people; in Brazil there are fewer than three.

The same pattern emerges when it comes to necessities. Some 74 percent of United States households currently enjoy access to clean water. In India, the comparable figure is 25 percent. In Germany there are 10 hospital beds for every 100 people; in Indonesia there is less than one.

The $64 trillion question is this: how can developing countries move quickly toward the standards of living now accepted as normal in the advanced industrial countries? Transforming pent-up demand into an engine of balanced growth is now a high priority for development policy.

Many developing countries face a situation similar to that of the advanced industrial economies in the middle of the 20th century. Having built the means of mass production, they must now find ways to stimulate and finance domestic mass consumption to substitute for export demand.

All the anecdotal evidence suggests that the markets of export-oriented economies remain shockingly inefficient at allocating capital to its most productive uses.

BALANCED GROWTH

To put it another way, the shift from export-oriented growth will almost certainly require a reduction in savings rates. Private and, in some cases, government consumption must rise as a percentage of GDP. And that will require big changes in spending patterns. In France private consumption represented 79 percent of GDP in 1995; in Britain the number was 85 percent. By comparison, private consumption in Thailand was just 54 percent of GDP; in China, 48 percent; in Malaysia, 53 percent.

Raising private consumption will require

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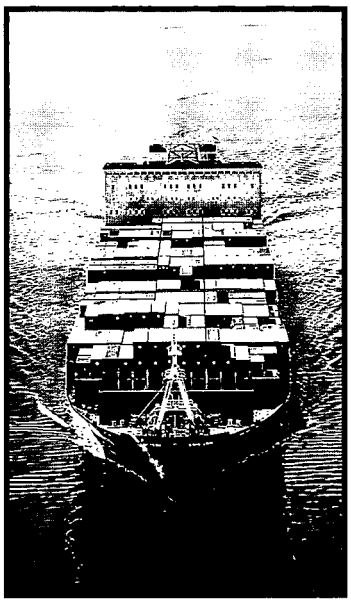
more than a shift away from taxes on consumption. In export-oriented economies, corporations have been encouraged to retain as much income as possible for future investment – often in unprofitable ways. Both shareholders and workers lose in the process. Reforms aimed at stimulating consumption (and at improving the efficiency of capital markets) would encourage higher dividend yields and perhaps higher salaries as well.



For planners steeped in 1980's thinking, all this is heresy. Certainly it would expose developing countries to a serious challenge – the substitution of foreign savings for domestic. Otherwise, increased demand in the domestic economy would likely lead to currency depreciation – an all-too-familiar spectacle from the last years of import substitution.

To make this strategy effective, the flow of foreign capital into emerging markets must increase dramatically. Developing countries must be able to consume more products produced in the South while exporting a smaller percentage of their output to the North – without experiencing the inflation that historically has dogged high spending developing countries.

An important part of the fix lies in the evolution of more effective domestic capital markets. And while figures are hard to come by, all the anecdotal evidence suggests that markets of most export-oriented economies remain shockingly inefficient at allocating capital to its most productive uses.

The catastrophically poor performance of capital markets in export-oriented economies is in part the result of deliberate state credit allocation policies, in part the result of cronyism and corruption. Improving the ability of these markets to make effective use of available capital would simultaneously reduce the need for foreign capital and make it easier to attract. And while capital market structure often reflects entrenched power relationships, the potential rewards for countries that can boost capital market performance are so great that even the most entrenched interests may give way.

As they introduce domestic reforms, developing countries must find ways to benefit from greater access to the global capital market while defending themselves from its perils. This means using the unprecedented power and flexibility of the international market system to tap long-term capital, while reducing exposure to short-term fluctuations and crises.

While "dollarization" – effectively making the dollar the national currency – has shortcomings for developing economies, it does offer certain countries (especially in Latin America) a real opportunity in this vein. In particular, dollarization would make it easier for them to tap securities markets. Thirty-year mortgages in Argentina could be packaged and securitized much as they are in the United States with the help of Fannie Mae. Such securities would offer Argentina a relatively stable source of long-term credit, while providing investors with a liquid asset that could be bought or sold at will – without pro-

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voking an economic crisis in Argentina.

In economies where, for either political or economic reasons, dollarization won't fly, there are other ways in which contemporary capital markets could provide attractive new options.

The current model in which the dollar, the euro and the yen all serve as media of global exchange whose relative values fluctuate without undermining the status of each could provide interesting opportunities for the creation of artificial currency units.

East Asian countries might use a currency unit that tracked, say, the yen or the dollar at any given moment – depending on which was the weaker. East Asia would gain the advantages of a stable unit of value, whose fluctuations would be easy and cheap to hedge in the global markets, while their economies would be partially shielded from the consequences of rapid changes in the value of the parent currencies.

Managed by a regional central bank, the "yendo" could buttress a securities market that would attract significant long-term capital to the region at lower rates than would otherwise be available. Modest capital controls, modeled on the Chilean approach, could be used to discourage short-term capital flows.

Besides reducing the cost of capital across the "yendo" region, a currency regime of this kind offers other advantages. Giving a regional central bank responsibilities as a lender of last resort would necessarily entail giving it regulatory responsibilities as well. And since capital-market development is one of the most urgent and difficult tasks facing export-oriented economies, a regional authority that commanded the respect both of foreign governments and investors could play a critical role.

Both dollarization and regional currency regimes would require much closer supervision of financial institutions and capital markets by the International Monetary Fund and other multilateral lenders.

That would no doubt be resisted in the name of sovereignty. However, proposals offering both a fast track to cheap capital and higher domestic consumption would likely meet less resistance than previous attempts to introduce transparency into developing financial markets.

Central bankers are never universally beloved, and one of their jobs must always be to provide local politicians with convenient scapegoats when economic troubles strike. But policies like the Argentine convertibility plan, which allows ordinary people to tap credit markets, have proved surprisingly popular – even when their introduction was accompanied by painful retrenchment and recession.

Other initiatives could be part of a Take Three development strategy. For example, the United States could certify Mexican health care providers as sufficiently well trained to qualify for reimbursement for services under U.S. social insurance programs – at perhaps at 60 percent of the prevailing rates north of the border. This would give an enormous boost to the development of retirement communities in Mexico for the ballooning population of older U.S. citizens – not to mention cutting Medicare costs.

The changes contemplated may seem radical. At the very least, they would require openness to fresh ideas. But it is hard to think of a higher priority for global economic policy. Export-led growth is heading the way of import substitution. And sooner rather than later, we must find an alternative that both developed and emerging economies can live with. M

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WRESTLING with Bankruptcy

The economics – and politics – of reform

By Joseph S. Pomykala

Only suckers pay their bills.

Ready for some big numbers? In 1998 – seven years into an economic boom – one out of every 68 households in the United States filed for bankruptcy. Bankruptcy filings each year are now more than double the number that occurred during the entire decade of the Great Depression.

Are Americans becoming more inept at financial management? Are they victims of the moral decay politicians and pundits preach about? It's possible. But the root cause is depressingly simple: Legal incentives make it much too attractive to shed personal debt through bankruptcy.

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BANKRUPTCY

First things first. Widespread debtor distress seems inconsistent with the longest boom and the lowest unemployment in a quarter century. But in part, the paradox of bankruptcy amid plenty can be explained by a fairly familiar cycle in consumer confidence.

During periods of economic growth, consumers use current economic conditions as a proxy for their future ability to repay. Prosperity and optimism lead consumers to take more risks and incur more debts. Those who guess wrong pay the price – insolvency.

But when a recession hits and consumers turn pessimistic, savings rates increase and they pay down debt. For example, during the great economic prosperity of the 1920's, people threw caution to the winds and bankruptcies more than tripled. During the Great Depression that followed, bankruptcy filings actually fell.

A similar cycle seems to be at work today – but one that has been supercharged by changes in the financial system, which have broadened and deepened access to credit.

Consumer debt has increased an average of 8 percent annually over the last 20 years, with the average family carrying $58,500 in liabilities at mid-decade. Most of the current debt is still in the form of residential mortgages. But unsecured credit has grown by an average of 14 percent annually since 1978, mainly through credit-card borrowing. Thus, about 43 percent of non-mortgage consumer debt is now in the form of revolving credit, compared to just 14 percent in 1978. What's more, the median balance carried by those who use credit cards to borrow grew by half from 1992 to 1995.

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The growth in credit-card lending was spurred by a 1978 Supreme Court ruling that allowed banks to lend across state lines, permitting them to place their offices in states without usury laws, and thereby evade usury laws in their customers' states. At higher interest rates, banks could profitably expand lending to high-risk groups. But there was a downside: Consumers could easily erase such unsecured debt through bankruptcy.

The democratization of consumer credit has a parallel in the changing environment for business credit. Financial innovations and expanded markets for high-yield corporate debt during the 1980's enabled firms to borrow and expand. Similarly, the greatly expanded availability of consumer debt during the last 20 years increased opportunities for consumers who could not borrow prior to the lifting of state interest rate ceilings.

Credit-card companies were left more exposed, since increased personal bankruptcy typically obliterates unsecured debts. But higher interest rates on credit-card debt – now averaging 16 percent – reflects this risk and compensates lenders for it. Consumers thus pay up front for their ability to discharge debt in bankruptcy. The downside, of course, is that they cannot legally waive this right in return for, say, lower interest rates.

Computerized credit scoring of applications for loans does allow lenders to discriminate between high- and low-risk borrowers. But there are practical limits to such differentiation, because of the prohibitive costs of fuller credit investigations relative to the small size of unsecured loans.

Consider a credit card company lending one million consumers $2,000 each. The company earns, say, $300 in interest per account and must write off 5 percent of the loans annually. It could substantially reduce the default rate by interviewing potential bor-

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rowers, calling their prior employers, rating job security and the like. But the costs of such screening would far exceed the benefits. So consumer lenders tend to pool unsecured debtors, charging everyone more or less the same rate. And that implies the better quality debtors subsidize the riskier borrowers.

TOO MUCH DEBT? PROBABLY NOT.

Consumer debt, as we've noted, has increased sharply in recent decades. But the consumer debt-service burden – the portion of income the average household pays to service interest and principal payments – fell from 15.6 percent to 15.4 percent between 1989 and 1995. By the same token, the value of consumer assets, mainly primary residences and liquid financial assets, has grown at about the same rate as indebtedness. Thus, consumer leverage has remained constant and the ability to service debt has marginally improved.

In the same period, though, the personal bankruptcy rate increased by one-third. Debtor distress did not contribute to the rise, especially in these rosy economic times. Rather, the incentives to declare bankruptcy have increased: More debt means more can be shed through legal insolvency.

DECLINING MORAL SCRUPLES?

It's difficult to measure changes in attitudes toward bankruptcy. But many would agree with Judge Edith Jones of the National Bankruptcy Review Commission, who notes that "at one time in our history, filing bankruptcy was regarded as shameful, and filers suffered social stigma and permanently ruined credit. The shame and stigma are no longer compelling.... Many debtors are well off and continue to be fully employed before and after filing bankruptcy.... Well publicized celebrity bankruptcies, plus "water cooler" gossip about increasing filings, have tended to reduce bankruptcy to an acceptable alternative for personal financial management."

Indeed, the discharge of unpaid debts has become more a tool of smart financial management and less a matter of embarrassment. Some mortgage brokers even recommend bankruptcy to loan applicants in order to remove high debt loads and qualify potential home buyers for new loans from lenders who are more concerned about debt load than past credit history.

STEVE EDSON/PHOTONICA

A FINANCIAL WINDFALL? PASS THE WORD.

Economists do not wonder why the bankruptcy rate is so high, but why it's so low. Michelle White of the University of Michigan estimates that a whopping 15 percent of households in the United States could financially benefit from bankruptcy. Yet less than a tenth that many actually file.

Even more than 15 percent could benefit if consumers employed what economics call strategic behavior prior to bankruptcy. If debtors converted nonexempt assets to legally exempt property – using cash to contribute to IRAs or to pay off or reduce home mortgages – the percent that could benefit rises to 18 percent. And if debtors moved to states that

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allowed the highest property exemptions, the figure rises to 23 percent.

Presumably, one reason filings are not higher is the moral cost attached to bankruptcy. However, it's hard to believe that such scruples explain all of the hesitation to shed debt. A better explanation is linked to information – or, rather, a lack of it. Simply put, many debtors are unaware of the sweetheart deal awaiting them until they seek legal advice or talk to friends who have used bankruptcy to shed debt.

This is the information age and – no surprise – the information gap is narrowing. After the United States Supreme Court ruled in 1977 that state laws banning lawyers from advertising violated free speech rights, legal advertising grew rapidly. Spending by lawyers on television ads alone grew from $5 million in 1980 to $129 million in 1994. Bankruptcy filings began to accelerate about the same time, and according to a study by the Federal Deposit Insurance Corporation, the correlation was not coincidental. More people are finding out about the financial windfall available through bankruptcy and taking advantage of the opportunity.

HARD TIMES, AMERICAN-STYLE

Seventy percent of personal bankruptcy filings occur under Chapter 7 of the bankruptcy law, and are known as liquidations. Debtors retain all the property that Federal law or the laws of their states shield from creditors, while the rest of their assets are used to pay off their debts *pro rata*. Any debts not paid in full are then wiped off the books.

Future income cannot be garnished to pay past debts. An investment banker earning $1 million a year is as entitled to a full discharge as a welfare mother.

Exemptions to what creditors take can be generous. In some states, homestead exemptions are set by acreage, as opposed to value. Florida's 160-acre exemption allowed Paul Bilzerian, the well-known corporate raider, to retain a $6 million, 11-bedroom, 20-bath mansion near Tampa. And rules set for 19th century farmers still apply. In a Virginia case, a bankrupt was allowed to keep his "one horse" – an $800,000 thoroughbred purchased just prior to filing. Courts have also permitted debtors to keep mink coats, Rolex watches and expensive jewelry as clothing protected from creditors, and valuable antiques as exempt household furnishings.

Unfortunately, the outrageous is not atypical. Chapter 7's title, "Liquidation," is plainly a misnomer, since, in 96 percent of cases, creditors receive nothing. Liquidation, in practice, is merely a few pages of paper filed with the court to remove unwanted debts.

Alternatively, debtors can choose Chapter 13 of the bankruptcy law, which provides what is known as a wage-earner discharge. The debtor keeps all his assets, not just the exempt ones, and attempts to pay back some of his debts over three to five years with income left after provision for living expenses. But even here, many judges seem inclined to aid debtors and third parties at the expense of creditors. Approved expenses have included tithing to churches, gifts, vacations and private-school tuition for dependents when public school is available.

Discharges of debt under the bankruptcy law are generally limited to every sixth year. But once the forbidden fruit is bitten, many bankrupts come back for seconds. Approximately 8.6 percent of filers have declared bankruptcy once before; 2.5 percent have declared three or more times.

The ease of obtaining a discharge has plainly led to abuses. Just how common these abuses are is hard to say, but the anecdotal

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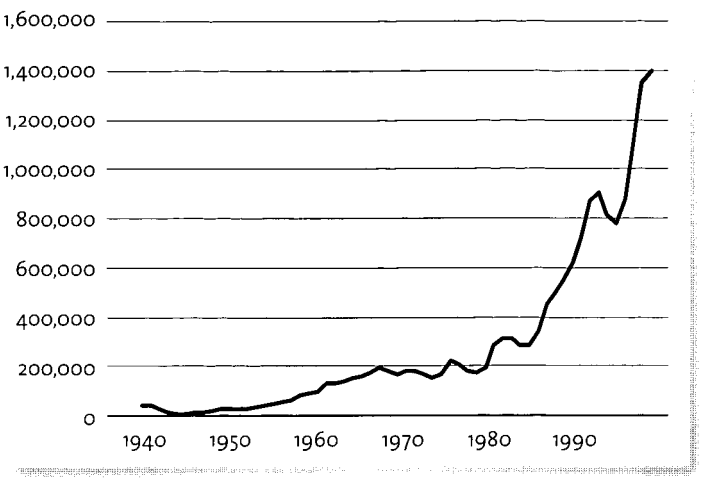
evidence makes for juicy reading. One physician took his family on a six-week, $60,000 European vacation charged to his American Express card, and upon return declared bankruptcy. An unemployed New York waiter amassed debts of $170,500 over six months for airline tickets, consumer electronics, perfume, cosmetics and gambling in Atlantic City. He obtained $50,000 in cash advances on his credit cards, claimed he lent funds to a friend who disappeared, and asked the court to absolve him of his debts.

CONSUMER BANKRUPTCY FILINGS IN THE U.S. 1940-1998



IT WASN'T ALWAYS THIS WAY

Roman law allowed debtors to post their bodies as loan collateral; upon default they were sold into slavery to satisfy creditor claims. In colonial America, the palms of those convicted of bankruptcy were branded with a "T" for thief. It was also common practice to nail a bankrupt's ear to the pillory in a public place for several hours before it was cut off. The "earmark" served to warn future creditors that the person was not a reputable person with whom to contract debts.

Early exemptions in the colonies were meager – mainly for clothing – and the discharge of indebtedness was forbidden until the early 18th century. It was a reward for honest debtors who showed up for court and revealed their property instead of fleeing. And it could only be granted if a four-fifths majority of creditors approved.

When the U.S. Constitution was framed, bankruptcy was a form of criminal fraud. Creditors were plaintiffs accusing defendant debtors of committing acts of bankruptcy – typically absconding with property. In England, bankruptcy was a capital felony and convicted debtors could be sent to the gallows. While the United States copied much English jurisprudence, the death penalty was replaced by a maximum 10 years' imprisonment when the first Federal statute on bankruptcy was enacted in 1800.

Bankruptcy law was at first aimed at recovering a bankrupt's assets and allowing creditors an equitable share of them. But the law slowly evolved into a system for debtor protection, a means of bestowing creditor-funded debtor relief during economic crises.

After the Panic of 1837 – then the deepest depression in America's history – debt relief became part of the Whig Party's presidential platform. The 1841 Bankruptcy Act widened eligibility to all debtors, where before only merchants and traders had been eligible. It also allowed debtors to voluntarily petition themselves into bankruptcy, instead of giving the option only to creditors. But the liberal new law quickly led to wide-scale abuse. Friends and family of debtors would claim fictitious debts, share in the distribution from

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the estate, and then vote for a discharge. The law was repealed after 13 months.

The 1867 Bankruptcy Act was designed to cope with bad debts arising from Civil War losses. Creditors' rights to vote over a bankrupt's discharge were cut back. States were allowed to set their own property exemptions, and those in the South legislated generous homestead exemptions in order to prevent Northern creditors from gaining title to Southern property. Amendments after the Panic of 1873 further weakened creditor voting rules. But, in an echo of 1842, the Federal law was repealed after a return to prosperity and rising popular distaste for abuses of debtors' rights.

Once again responding to general economic distress, Congress passed the Bankruptcy Act of 1898. The new law abandoned creditor voting in consumer bankruptcies. And this time around, the law survived a return to prosperity.

Welfare, food stamps, social security, disability, Medicaid – all are means tested. Bankruptcy ought to be means tested as well.

The Great Depression led to another ratcheting up of debtors' rights. Congress introduced payment plans for wage earners lasting three to five years, during which secured creditors – like mortgage-holders – could not enforce liens. Business reorganization became an alternative to liquidation. And municipalities were added to the list of entities that could discharge unpaid debts.

The law was changed again in 1978. The amount of personal property retained by debtors increased, and eligibility for Chapter 13 wage-earner repayment plans widened to allow debtors with significant equity in their residences to file for bankruptcy without losing their houses. This came on top of the Supreme Court rulings that effectively eliminated state usury caps and allowed lawyers to advertise. Consumers could easily borrow more and lawyers could more easily proselytize for bankruptcy, spreading the word of how they could painlessly rid clients of unwanted debts.

SOMETHING MUST BE DONE

Congress established a bipartisan National Bankruptcy Review Commission in 1994 to redraft the nation's bankruptcy laws again. But it imposed no particular mandate, and Commission appointees quickly split between pro-debtor and pro-creditor factions.

The Commission submitted its final recommendations in 1997. But the proposed amendments did not attempt to curb the skyrocketing bankruptcy rate. Indeed, some provisions actually increased debtors' benefits, and the proposal proved dead on arrival on Capitol Hill. Those seeking serious reform quickly drafted alternative legislation aimed at curbing growing abuses. Their proposed changes – still pending – soon become known as means testing.

Under existing law, debtors filing under Chapter 7 liquidation can often keep virtually all their property under generous personal property exemptions, and even repeat the process every six years. No test exists to see if bankrupts could otherwise repay debts from future income.

But under proposed means testing

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reforms, debtors would be ineligible for Chapter 7 relief if they were likely to have an easy time paying back a portion of their debts later on. Those debtors could still file Chapter 13 plans, using disposable income to pay back debts over three to five years.

This hardly amounts to a return to Dickensian remedies. The means test would not apply to debtors with incomes less than the median American income – about $51,000 for a family of four. Those above the median would only be eligible for a quick discharge under Chapter 7 if they could demonstrate that they could not repay at least 25 percent of their unsecured debts from discretionary income over a five-year period.

However, some 80 percent of all filers would flunk the median income test, and only half of the other 20 percent would have sufficient income to pay back the minimum fraction of debts under a Chapter 13 plan. Thus, a creditor-funded study by Ernst & Young estimated that the bill's means testing provisions would reach just 10 percent of Chapter 7 filers and result in just $4 billion more recovered by creditors annually.

Judge Edith Jones defended the means-testing approach at Congressional hearings. Welfare, food stamps, disability and Medicaid are all means tested, she noted. "Bankruptcy is part of the social safety net. It ought to be means tested as well."

Needless to say, though, this view was not unanimous. Opponents of the changes include attorney groups who are getting rich off the bankruptcy boom (lawyers now earn more than twice as much from the Chapter 7 bankruptcy system as unsecured creditors manage to recover from bankrupts).

On the other side is the credit card industry. Over the last decade, uncollected debts as a percentage of all credit-card loans has doubled. In a study funded by Visa, the credit card consortium, Wharton Econometric Forecasting Associates estimated the financial costs of bankruptcy in 1997 at $44 billion – mostly discharged unsecured debt. If these costs were borne entirely by consumers, they would amount to $400 per household, or four percentage points more in interest on unsecured loans.

Since a minority of debtors who would be affected by means testing, the reform seems unlikely to reverse the trend in bankruptcy filings. But, then again, it might. The administration of the means test – estimating income, expenditures and creditor recovery under hypothetical Chapter 13 plans – would significantly add to the administrative and legal costs of bankruptcy. Thus the up-front costs of declaring bankruptcy could easily double, presumably deterring some debtors from taking this road to the Promised Land.

AND THE BEAT GOES ON

The battle over bankruptcy reform is plagued by misunderstanding. Bankruptcy is not a form of creditor-funded relief for debtors. Since the market for consumer loans is competitive, lenders ultimately pass on costs to borrowers, leaving all debtors to pay in the form of higher interest rates and more stringent loan qualifications. Thus, means testing would actually help most borrowers – especially low-income borrowers – who would more easily qualify for loans and pay lower interest rates.

Whatever the rhetoric, the politics will play out as a contest between lawyers and the credit card industry. Imposing means testing is not likely to significantly stem the growing tide of filings. But some day, some way, Americans are going to have to face the reality that the inability to enforce contracts between creditors and debtors creates real costs that someone must pay.

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The Federal Reserve's performance under Chairman Alan Greenspan has been nothing short of miraculous. During his tenure, inflation has almost been eliminated, economic growth has been rapid and unemployment has fallen to levels not seen since the 1960's. This stellar record has led the media to elevate Greenspan to something approaching movie-star status. The financial markets apparently cannot imagine anyone else at the helm of the Fed, and several presidential candidates have already come out in favor of his reappointment – even though the Chairman's term does not expire until next year.

But Alan Greenspan will not always lead the Fed – he is in his 70's, after all – and current technology is not up to cloning him. More important, just as the biggest box-

RIGHT: ROBERT C. BURKE; TOP: GEORGE DE KEERLE/BOTH LIAISON INTERNATIONAL

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office star turns out the occasional bomb that goes straight to video, even the best central bankers make mistakes. That is why movie studios bet on their production systems rather than on their stars – and why the Federal Reserve should be thinking through its approach to monetary policy A.G. (after Greenspan).

Is there anything (beyond burning incense and singing hymns) that can be done to increase the chances that U.S. monetary policy will stay on track without the input of another Greenspan? We think the answer lies in a strategy known as inflation targeting that has been employed with great success by several countries, including Canada, New Zealand, Australia, Sweden and the United Kingdom. Inflation targeting not only offers hope of consolidating the gains of the Greenspan years, but would also make monetary policy more transparent and accountable to the public. And that's a good thing for both the financial markets and the democratic political system.

I N G

Fed Policy after Greenspan

By Ben S. Bernanke, Frederic S. Mishkin & Adam S. Posen

How to diet without a lock on the refrigerator door.

CURRENT FED PRACTICE: JUST DO IT

Unlike many central banks, the Fed is relatively opaque and secretive in its policy-making. It has never clearly articulated precise policy goals to Congress or to the public. Nor does it lay out, even in the most general terms, the contingencies that would cause it to contemplate changing its stance on monetary policy. Less obvious, but no less important, the Fed does not provide a nominal anchor for the economy – an explicit target for, say, the growth of the money supply, the exchange rate or, as we will advocate,

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for the rate of inflation, on which people can base their expectations about future price levels.

This is not to say that the success of U.S. monetary policy in the 1990's was an accident. The Fed has communicated the benefits of stable prices with sufficient conviction to give it the political breathing room to fight inflation. And fight it has: After bringing down the rate of inflation, the Fed has carefully monitored the economy for signs of incipient price pressure and undertaken periodic preemptive strikes in the form of interest rate hikes.

Alan Greenspan will not always lead the Fed and current technology is not up to cloning him.

For example, from February 1994 to February 1995 the Fed tightened credit by doubling the rate at which banks could borrow money overnight (from 3 percent to 6 percent) even though inflation showed no overt signs of stirring. This preemptive action must be judged a success, since inflation has remained low even as the economic expansion continued. And in recent months the Fed has again been raising interest rates in an attempt to strangle the inflation monster before it comes out of its lair.

The long lag between monetary-policy actions and their effects dictates the need to alter course before prices accelerate. If a central bank were to wait for inflation to rise, the opportunity to maintain stable prices with only modest interest rate hikes would be lost. For once inflation has been allowed to gather momentum, higher inflation expectations become ingrained in a variety of long-term business agreements ranging from union wage pacts to contracts with suppliers. And that makes inflation both more difficult and more costly to eradicate.

In the past, the Fed often made the mistake of waiting to respond to inflationary pressures. But Greenspan took the academic research on the importance of expectations and preemptive policy-making to heart, and the Greenspan Fed has consistently tightened credit before inflation reared its noxious head. Earlier action has meant less severe action, allowing the Fed to avoid the nasty recessions associated with inflation fighting in the 1970's and 1980's.

While the combination of a commitment to price stability and a strategy of preemptive strikes has yielded good results, it is not clear that we should be satisfied. We call the Greenspan Fed's strategy the "just-do-it" approach, because it lacks an explicit, publicly articulated goal and a coherent framework.

IF IT AIN'T BROKE, WHY FIX IT?

In light of the success of the just-do-it strategy, it's only natural to ask why the Fed should consider alternatives. The answer is that just-do-it has some disadvantages that will likely cause it to work less well in the future. Indeed, the lack of a clear policy framework is already being felt in subtle ways.

One limitation of policy-as-usual is its lack

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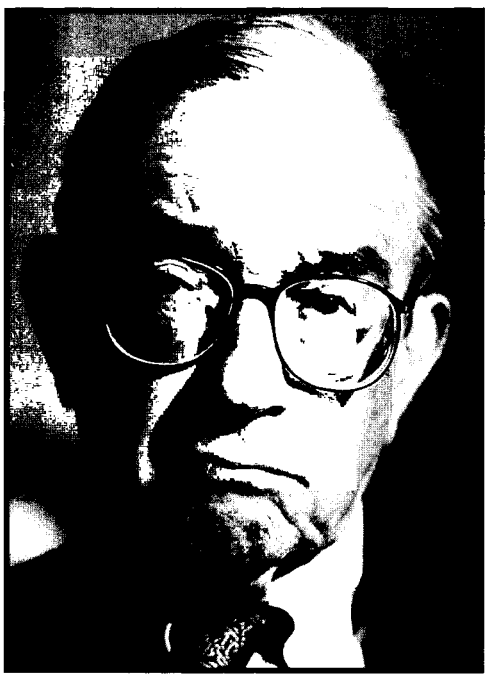
of transparency: The fact that the Fed remains unwilling to share its thinking with the public. The endless guessing games about Fed intentions engendered by its close-mouthed approach increases volatility in financial markets and generates unnecessary uncertainty about the future of the economy.

What's more, the secrecy is hardly conducive to making the Federal Reserve accountable to Congress and the public, since it leaves no explicit criteria for judging the Fed's performance. Perversely, the absence of explicit performance benchmarks may create leeway for opportunist politicians to pressure the Fed to pursue short-term objectives (e.g., a temporary and unsustainable burst in job creation) at the expense of long-term ones (e.g., price stability). There is no reason to think that increasing transparency would come at the cost of macroeconomic performance. In fact, evidence from other countries suggests that transparency actually improves the performance of monetary policy.

The lack of an explicit nominal anchor is also a problem in the context of a just-do-it approach. For example, under its current practices, the Fed risks unnecessary exposure to inflation scares – those occasional, seemingly spontaneous increases in inflation expectations that drive up interest rates on bonds and mortgages. In addition, the lack of a nominal anchor makes it harder for the Fed to contain the effects of adverse supply shocks, like a jump in the price of oil. For with nothing to tie them down, inflation expectations are more sensitive to transitory increases in prices.

Probably the most serious problem with just-do-it, however, is its strong dependence on the preferences and skills of central bankers – not to mention the faith of the public in fallible policy makers. In the United States, Greenspan and other Fed officials have



GEORGE DE KEERLE/LIAISON INTERNATIONAL

emphasized inflation control through forward-looking policies. The Fed's prestige and credibility with the public have risen in tandem with the great success of these policies to date. But the Fed's leadership will eventually change, and there is no guarantee that the next team will be committed to the same goals or forward-looking tactics – or that the new policy makers will be as skillful at it.

By the same token, there is no guarantee that the relatively good working relationship between the Fed and the executive branch will continue. Nor is there any assurance that the public would support the Fed's commitment to price stability, should economic times turn tougher. In short, a just-do-it policy does not build sustainable credibility.

In fact, in a different economic or political environment, a less-than-transparent Fed might face strong pressure to engage in over-expansionary policies. There are historical examples – notably, in the late 1960's and the 1970's – of the Fed abandoning successful

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low-inflation policies in favor of expansionist inflationary policies. And without an explicit policy anchor, that could happen again.

Evidence from other countries suggests that transparency actually improves the performance of monetary policy.

WHAT IS INFLATION TARGETING? AND WHY IS IT A GOOD IDEA?

There is a well-tested alternative to a just-do-it policy directed by a strong Fed chairman. "Inflation targeting" commits the central bank to forward-looking pursuit of low inflation – the source of the Fed's current success – and also enhances the central bank's accountability and transparency. As we noted, inflation targeting has been adopted by a number of major industrialized countries and, more recently, by emerging-market economies, including Chile, Israel, Mexico and Brazil. The strategy has been associated with the maintenance of historically low levels of inflation and, as important, strong public support for policies aimed at stabilizing prices.

The basic premise of inflation targeting is that the central bank and the government must make a public commitment to an explicit target level for inflation, to be achieved over some medium-term horizon. Further, the central bank must provide markets and the public with enough information to judge its performance and to understand the logic behind its tactics. The very public goal-setting and reporting inherent in inflation targeting makes the central bank accountable with a minimum risk of political interference. Political pressure is channeled into healthy interest in the central bank's effectiveness in meeting its stated inflation goal, as well as into debate about the appropriate level for the inflation target itself.

More explicitly, inflation-targeting consists of the following elements:

- Public announcement and definition of a numerical target for inflation (usually around 2 percent a year) and a time frame (usually between one and two years) over which the target is to be attained.
- An explicit commitment, by both the central bank and elected officials, to price stability as the primary long-run goal of monetary policy.
- Use of a broad range of relevant information in making monetary policy, rather than a focus on a single variable, such as the growth of the money supply.
- Publication of inflation forecasts, with a description of the circumstances under which policy would change.
- Expanded communication about the plans and objectives of monetary policy-makers through regular, comprehensive and clearly written publications.
- Increased accountability of the central bank for attaining its inflation objectives.

Experience in other countries shows that inflation targeting provides a good balance of transparency and flexibility. And we think it would serve to institutionalize, and thus to perpetuate, many of the positive features of current practice by the Greenspan-dominated Fed. After all, this Federal Reserve Board stands for low, stable inflation and it has taken a forward-looking approach in its preemptive strikes on inflation.

Adoption of inflation targeting by the

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Federal Reserve would have several major advantages over "policy making as usual". First, it would depersonalize U.S. monetary policy. This is not to deny that Chairman Greenspan and the current Federal Open Market Committee (consisting of the Fed Board of Governors and a smaller group of regional Fed bank presidents) have served us well. But there is a reason why Americans generally prefer to be ruled by laws than by men, and the mistakes of the Fed in the 1930's and the 1970's reinforce the point.

Second, inflation targeting would be an improvement over current practice in that it would increase the transparency of policy-making. It would build on a number of recent steps taken by the Fed, notably the shortening of the time before minutes of Federal Open Market Committee meetings are released, the decision to announce whether the interest rate target has been changed immediately after the committee's meeting, and the announcement of the direction of bias – up, down or neutral – of future interest-rate policy. Yet there is no reason to be so cautious in expanding transparency. A wide-open door would promote better public understanding of Fed policy-making, leading to a more informed public debate – and, we are convinced, to better policy outcomes.

Why better outcomes? Inflation targeting encourages both politicians and the public to focus on what monetary policy can do (namely, maintain long-run price stability), rather than on what it cannot (create permanent increases in growth through expansionary policies). Easy credit has too often been seen as a quick fix for the economy because it creates output and jobs in the short run. However, both experience and extensive research shows that turning on the money spigot cannot sustain such increases for long. On the contrary, it leads to higher inflation, with harmful consequences for the economy in the long run.

Inflation-targeting frameworks in other industrialized countries have nudged the political debate toward a more realistic, longer-run perspective. An excellent example occurred in Canada in 1996, when the president of the Canadian Economic Association criticized the Bank of Canada for pursuing what he claimed was an excessively contractionary monetary policy.

His speech sparked a widespread public debate. In countries not pursuing inflation targeting, such debates often degenerate into calls for immediate easing of monetary policy, with little reference to the long-run consequences.

A wide-open door would lead to more informed public debate – and to better policy outcomes.

In the Canadian case, however, the inflation-targeting framework pushed the debate into a substantive discussion of what the target for inflation should be and how quickly it should be attained. Both the Bank and its critics were obliged to make their assumptions explicit and to estimate the costs and benefits of different levels of inflation. In the end, the Bank of Canada's openness and responsiveness led to increased support for the Bank's policies, with the result that criticism of the Bank's tough anti-inflationary measures did not have much impact on the 1997 elections – as it had in 1993.

Increased transparency would also reduce financial and economic uncertainty. More

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information from the Fed about its objectives and plans could reduce the costs incurred by financial market players, who now spend too much of their business lives guessing about what the Fed will do next. Greater transparency would also make it easier for businesses and consumers to plan for the future – i.e. whether to commit to long-term contracts, when to refinance a home mortgage.

Third, an inflation-targeting framework is more consistent with democratic principles than other approaches. There are good reasons to grant central banks some degree of independence – notably, insulation from short-term political pressures. Indeed, there is strong evidence that countries with independent central banks enjoy lower rates of inflation than countries without them, with no greater volatility in employment or output. Yet the practical economic arguments for central bank independence co-exist uneasily with the presumption that government policies should be made democratically. Indeed, criticism of the Federal Reserve may in part be prompted by the impression that the Fed and its Chairman have become too powerful.

Since policy objectives in a democracy must ultimately reflect the popular will, they should be set by elected officials. Consequently, the central bank should not lay down the objectives of monetary policy. However, because the central bank has the best information and expertise on how to achieve policy objectives, it should be free to choose the means for getting the job done.

Inflation targeting is consistent with – and, indeed, promotes – this way of organizing responsibility. In the framework used by most countries, the central bank is fully accountable to elected officials, who have the primary responsibility for setting the goals for monetary policy and monitoring the outcomes. At the same time, the targeting framework ensures that the objectives set by the government are feasible and that they fit into a consistent long-run perspective. For example, this requires the government to choose goals for inflation (which is controllable by the central bank) rather than for, say, the long-run unemployment rate (which is not). Finally, under inflation targeting as it has generally been practiced, short-term operational decisions belong solely to the central bank.

Changes in the system for setting monetary policy in Great Britain offer an example of how inflation targeting reduces the tensions between central bank independence and democratic policy making. Prior to 1997, monetary policy decisions in the United Kingdom were made by the executive branch, in the person of the Chancellor of the Exchequer. However, on May 6, 1997 the new Chancellor of the Exchequer, Gordon Brown, granted independence to the Bank of England by giving it the power to set the overnight interest rate.

Brown made it clear that his action had been made possible by the earlier adoption of an inflation-targeting regime, which had increased the transparency of policy and the accountability of the Bank. He also pointed out that inflation targeting would enable the elected Government to continue to set the goals of monetary policy – as is appropriate in a democratic society – but at the same time would ensure that the Bank has adequate discretion in meeting the goals.

Fourth, the evidence suggests that the adoption of inflation targeting would make it easier for the Fed to deal with adverse economic shocks. For example, the Bank of Canada has emphasized that inflation targets have improved its ability to deal with contractionary shocks to demand. Because a decline in demand also leads to lower expected

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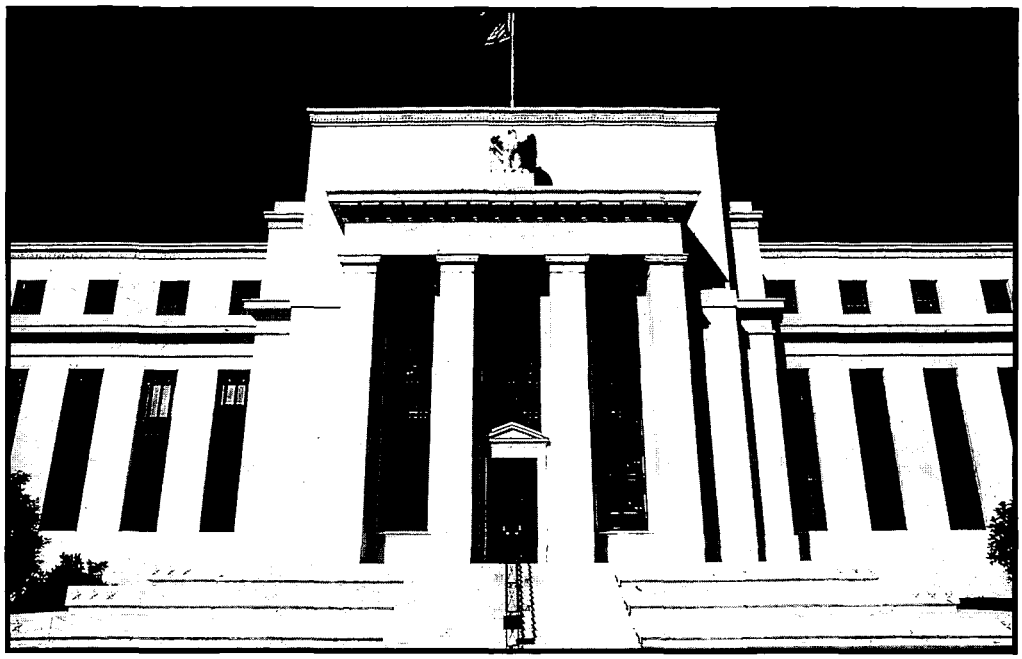

There is a reason why Americans prefer to be ruled by laws than by men – and the mistakes of the Fed in the 1930's and the 1970's reinforce the point.

inflation, the Bank has been able to respond with a monetary easing without causing the public (or the financial markets) to question its anti-inflationary resolve.

Inflation targeting is particularly good insurance against the threat of deflation, or falling prices. Deflation poses grave risks for the economy. Indeed, deflation has been associated with deep recessions or even depressions, as in the 1930's. And the recent bout of deflation in Japan has dogged efforts to repair that country's financial system and economy. Targeting inflation rates at levels a couple of percent above zero, as all inflation targeters have done, makes periods of deflation less likely. The evidence from both surveys and the behavior of interest rates suggests that maintaining a target for inflation above (but not too far above) zero does not lead to instability in inflation expectations or to a decline in the central bank's credibility.

Fifth, it seems likely that having inflation targets in place would give the central bank more flexibility to react to potential financial crises. For example, in the wake of the failure of a large financial institution that rattles financial markets, the Federal Reserve would be able to inject needed liquidity into the financial system with the knowledge that its medium-term targets will help to anchor

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inflation expectations.

The financial markets' reaction to Fed policy in the early 1990's is an example of what can happen when explicit inflation targets are not in place. In response to problems in the banking sector and credit markets, the Fed kept short-term interest rates fixed at the extremely low level of 3 percent (or about zero, in real terms) for more than a year. To rationalize this policy, Chairman Greenspan referred to the financial "headwinds" that were holding back the recovery.

Countries that have adopted inflation targeting have typically done so not when inflation is rising but after they have already achieved some success in taming prices.

Nevertheless, Wall Street expressed concern that the Fed was losing its anti-inflationary resolve – a concern that manifested itself in substantial increases in long-term bond rates when the Fed began raising short-term rates in February 1994. This response might well have been moderated had a credible inflation-targeting regime been in place.

Similarly, explicit inflation targets would have reduced the inflationary risks associated with the otherwise well-justified 75 basis point drop in short-term rates in fall 1998 – the Federal Reserve's policy response to the exchange-rate crisis in Russia and the near-collapse of Long-Term Capital Management.

WHY NOW?

We have argued that U.S. monetary policy, despite its excellent performance in the Greenspan years, would be likely to perform even better if the Fed formally adopted inflation targeting. But why now?

The reasons are largely political. Countries that have adopted inflation targeting have typically done so not when inflation is rising, but after they have already achieved some success in taming prices. That timing makes sense because it increases the likelihood the new regime will endure, as the central bank builds on its established credibility as an inflation fighter. Moreover, the public seems more willing to accept inflation targeting once it recognizes that low inflation can indeed be achieved, that it provides tangible economic benefits, and that additional short-run costs (in terms of lost output and employment) to bring down inflation may not be necessary.

The current situation in the United States thus seems highly propitious for the adoption of inflation targeting. Inflation has been low and stable for well over five years. The economy has been remarkably healthy, enjoying a balanced, long-lived expansion. The benefits of a low-inflation environment have become clear to the American public. And last but not least, the success of inflation targeting in other industrialized countries is becoming increasingly apparent.

Thus the United States has a window of opportunity in which a new monetary policy framework could be readily adopted. With luck, the new framework would be firmly established by the time the next difficult policy decisions have to be made, ensuring that they are likely to be the right ones – whether or not the Fed has Alan Greenspan at the helm. M

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True Security:

Rethinking American Social Insurance

ILLUSTRATIONS BY
TIMOTHY COOK

The big social-spending programs for the elderly have become the primary focus of Federal budget politics. Last year, Democrats rejected altogether-sensible suggestions for limiting the growth of Medicare in hope, of making political hay in the next election. Meanwhile, Republicans have joined in the demagoguery, attempting to pit younger voters, who presumably favor tax cuts, against baby boomers, who are worried that current budget surpluses will be spent before they get their turn at the Social Security trough.

Policy wonks see chances here to marshal public anxieties in the name of reform. Accordingly, the public-policy establishment is bubbling with plans to make over individual programs. But Graetz and Mashaw, veteran public-policy analysts at the Yale Law School, are coming from a very different place. Too much effort, they say, has been invested in redesigning individual programs, and too little on rethinking the safety net as a whole.

Their book is an incredibly ambitious consideration of social insurance from first principles. We offer a sampling from early chapters that lay the groundwork. Those interested in Graetz' and Mashaw's grand conception will have to spend $16.95 for the paperback, due out in November. — *Peter Passell*

BY MICHAEL J. GRAETZ & JERRY L. MASHAW

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Recall our childhood friends, the Three Little Pigs, children sent out by their mothers to seek their fortunes. Each meets a man who, simply for their asking, offers them building materials for a house – the first, straw; the second, twigs; and the third, bricks. Potential calamity soon comes calling in the form of a large-lunged wolf bent on huffing and puffing their newly built houses to the ground and eating the pigs. The wolf easily blows down the straw house, and has only a bit more trouble with the one built of sticks. But the third pig, who had made his house wind-proof by building it out of bricks, ultimately triumphs by enticing the wolf down his chimney into a pot of boiling water.

In the way that we tell this story to our children and grandchildren – a way no doubt influenced by an upbeat Disney cartoon version – the practical third pig not only saves himself but also the provides refuge for his two siblings, who have managed to escape the wolf.

The original version is harsher. The little pigs left home not because "the time had come to go," but rather because their mother "had not enough to keep them." The wolf devours the first two little pigs, and in a macabre but perfectly retributive finale, the third pig lives happily ever after only after eating the boiled wolf for dinner.

Virtually nothing is said about the first two pigs – but wolves, it turns out, are more than a residential threat. The third pig goes apple picking and to a fair, with the wolf following; this pig ultimately escapes only by rolling home in a butter churn fortuitously found nearby.

As with all fairy tales, there is a morality lesson here. But there are many interpretations, as well as many versions. One interpreter is particularly sympathetic to the second pig; he regards him as having the sad luck to be "alone, small in a world filled with predators and not especially bright or industrious, just a Joe Sixpack adrift on a sea of fate without a paddle or enough sense to keep afloat." A modern, politically correct version has the wolf die from a heart attack from all his huffing and puffing coupled with a lifetime of eating food high in cholesterol.

Walt Disney, who told the most influential American version, used the story as a paean to cleverness, hard work and personal responsibility. Disney depicted the first two pigs as foolish and lazy, wanting only to sing and play all day. He even named them Fiddler and Fifer, in sharp contrast to their hardworking brother, Practical. But in Roald Dahl's version, the third pig is too clever by half and ends up as a pigskin purse for Little Red Riding Hood. Having a brick house is good wolf protection. Yet building a brick house may take too long, leaving the industrious (but too fastidious) builder without shelter when the wolf happens by.

The authors view these tales as a complex meditation on the question of true security, and as a strong suggestion that no single strategy for achieving it is foolproof. Pigs who seek opportunity in the world can come to grief, but stay-at-homes may find their resources are too meager to provide for their families. We all sometimes benefit from the generosity

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of strangers, but how much their kindness adds to our security depends on what we do with what we are given. When planning our lives to maximize our own security, the long view may be prudent – or a formula for disaster. Individual responsibility is crucial, but it will not guard us against all hazards.

THE HOUSE THAT ROOSEVELT BUILT

When the Disney cartoon was released in 1933, the Big Bad Wolf was widely taken as a metaphor for the Depression. The finale, with all three pigs merrily singing "Who's Afraid of the Big Bad Wolf," was viewed as an appropriate and uplifting response to those hard times – a national rallying cry.

While the Disney cartoon was providing homiletic encouragement to a frightened populace, Franklin Roosevelt was trying to shape his own response to the Depression. He had no intention of rewarding laziness or inventing incentives for indolence. But he recognized that in modern America, true family security was both an individual and societal responsibility. Roosevelt's Committee on Economic Security produced a comprehensive blueprint for social insurance in the United States – a program that was designed to keep at bay the wolves of cyclical and structural unemployment, along with those that took the form of the absence, premature death, illness, disability or old age of the family's breadwinner.

Congress failed to deliver the full brick house Roosevelt desired, but he did get the Social Security Act. That law provided immediate aid to the elderly poor and to poor dependent children and their adult caregivers. It also began the program of retirement pensions that is now virtually synonymous with Social Security.

Congress amended Social Security in 1939, adding spousal benefits for retirees, and survivors' benefits for the dependents of contributors. Simultaneously, a variety of jobs programs were put in place, of which the Works Progress Administration is the best known. Disability insurance was added in the late 1950's. Health coverage for the elderly (Medicare) and the poor (Medicaid) were

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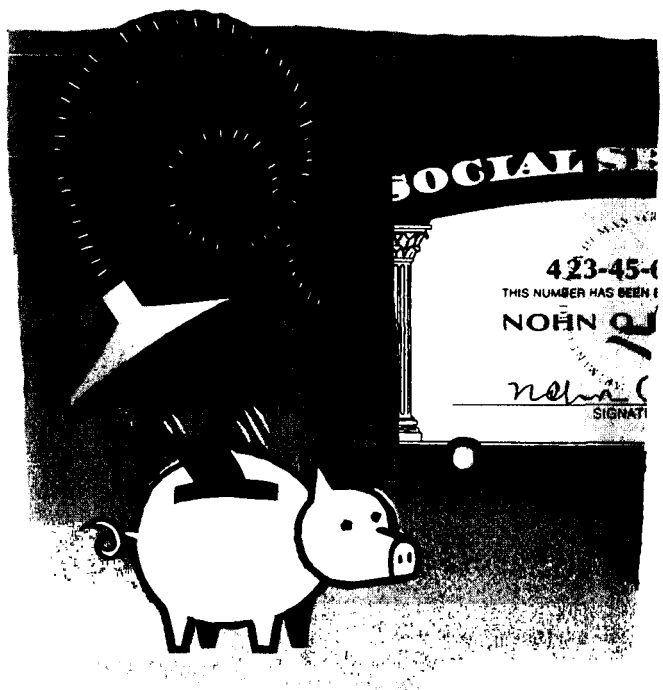
enacted in the 1960's. In 1970 the Supplemental Security Income program replaced earlier Federal support for state aid to the poor who are blind, aged or disabled.

Anybody's list of the most successful laws ever enacted by Congress surely would include both Social Security and Medicare. For decades, Social Security has been known as the third rail of American politics – meaning that any politician who tries to change it courts grave political danger. Medicaid, which provides health insurance for the poor, enjoys almost as much support – as do unemployment and disability insurance. Together these programs provide crucial, but incomplete, social insurance against risks to family economic security.



CONTEMPORARY CONCERNS

Today the edifice of social insurance begun in the 1930's faces huffing and puffing from many critics, who are prompted principally by a vision of future fiscal difficulties. The aging of the baby-boomers, along with increasing life expectancy, means that both Social Security and Medicare must increase their funding and/or reduce benefits. Medicaid had become the 800-pound gorilla of state budget politics, putting financial stress on the states and crowding out opportunities for program innovation. "Entitlement" is rapidly becoming a political epithet, notwithstanding the popularity of these programs and the impossibility of assuring financial security without a legally enforceable promise to pay.

Influential economists have argued that, despite their popularity, social insurance programs are costly to the nation's economy. They believe that Social Security and Medicare contribute to the nation's low rate of savings and are thus a drag on economic growth. Whatever the truth of that charge, the growth of payroll taxes to finance Social Security and Medicare has been stunning.

Middle-income workers now routinely pay more in wage taxes than income taxes, and many argue that workers are not getting their money's worth. By contrast, others complain that cutbacks in programs for the poor have destroyed the safety net. To listen to the critics, then, our social insurance protections today have become simultaneously inadequate and unaffordable.

Ideological opponents delight in characterizing Social Security as a Ponzi scheme, while knowing full well that the government's power to meet its obligations by raising taxes makes such a label absurd. Behind the hyper-

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bole, however, lie genuine problems and a real danger that the political support for social insurance could come unglued. America's young are said to doubt they will ever see their promised retirement benefits. And polls do reveal unprecedented levels of skepticism. At the same time, upper-income citizens are learning that they could achieve far greater financial returns from private investments than from Social Security. This threatens a political revolt of the haves like those that spurred popular state anti-tax measures such as Proposition 13 in California.

Fiscal and political stresses on social insurance programs are not unique to America. In Europe and Japan, the populations are older and aging faster that ours. And because of the greater ambitions of their social insurance, they already impose much higher payroll taxes than we do, leaving them much less room to maneuver. Hence both here and abroad a political battle is looming over the future shape of social insurance.

Social Security and Medicare contribute to the nation's low rate of savings.

But the debate is seldom described in those terms. Discussions are instead crisis-driven and linked to the immediate problems of one program or another. Rather than asking how much of what forms of social insurance Americans need and can afford, policy makers lurch from crisis to crisis. Fearing the political fallout from reshaping popular policies, they put this or that program's future into the hands of an advisory board here, a bipartisan commission there.

These politically insulated, ad hoc groups often devise temporary fixes for the fiscal troubles in one or another program and then disappear until a crisis looms somewhere else. This process cannot address fundamental issues of program goals or the means of reaching them. We seem never to have a national conversation about social insurance as a whole.

Indeed, while individual social insurance programs often engage our attention, "social insurance" is not a familiar term to most Americans. We are inclined to talk about Social Security or Medicare, about workers' compensation or unemployment compensation, about welfare or the Earned Income Tax Credit. Public concern and debate are limited to particular programs – and are usually occasioned by claims of scandal or projections of fiscal calamity.

Policy wonks do write jargon-filled essays about financing entitlements and about choices between universal and means-tested programs. But these limited exceptions prove the rule: Policy debates about social insurance are fragmented and seldom engage the fundamental question of how to provide Americans with effective and affordable protection.

This incomplete approach is a big mistake. We would think it foolish for a private household to debate whether it could afford a new winter coat for Grandma without considering whether the children need new shoes or whether the furnace is about to expire. Nor would it make much sense for a family to fret about the emptiness of Dad's pockets when Mom's wallet was stuffed with cash. But in the world of social insurance, we often fall into that sort of thinking.

For example, many have called attention to the nation's shocking childhood poverty statistics: One in four American children under the age of 6 lives in poverty. But this depressing

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tale is seldom connected to other stories that help explain it – the irrelevance of Social Security survivors' insurance to the single-, divorced- and never-married-parent households that account for a substantial percentage of childhood poverty; the increasing numbers of low-wage workers cut off from employer-based health benefits; the precipitous decline in the coverage of unemployment insurance; the always-spotty public and private protection against loss of earnings from illness and disability.

More examples could be given, but the point is clear enough: It has been too long since Americans have considered broadly what sort of social insurance they want and how much they are willing to buy. There is a critical need to expand the conversation to ask how existing programs relate to the overarching purpose of cushioning economic risks in a capitalist society. What combination of individual and collective action will produce the true security that we all want?

THE COMPLEX WORLD OF SOCIAL INSURANCE

To pursue those questions, we must do more than look at connections among social insurance programs. We must distinguish between the goals of social insurance and the programs that promote income security. For much that is social insurance in the panoply of American income security programs is hardly recognized as such.

The popularity and success of big programs like Social Security and Medicare induce a sort of historical amnesia. Unless a program is structured like one of them, with wage tax contributions, trust funds, specific benefit packages, Federal administration and all the rest, we do not think of it as social insurance.

We forget that, like the Three Little Pigs, the 1930's architects of America's income protection programs used the materials that came to hand. They used general resources to deal with the most pressing problems of poverty in old age and to rescue the states' collapsing mothers'-pension programs. They engaged in massive public job creation, and they stimulated state unemployment insurance coverage by an almost comical Federal tax scheme that imposed a tax that was never meant to be collected.

In later years, private pension and health insurance was induced by massive tax subsidies to employment-based plans and to individual retirement savings. Disability coverage was begun through a grant-in-aid program that was partially financed and wholly administered by the states and limited to the needy.

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But that program eventually became a supplement to the Federal disability insurance program put in place in the mid-1950's. A decade later, Medicare for the elderly was added.

But even Medicare flouts the conventional social insurance model. Hospital payments are financed by a payroll tax, but physicians' services are covered by voluntary private premiums that are subsidized by a massive infusion of Government funds. Health care coverage and pension savings for active workers have been subsidized by "tax expenditures" – that is, the failure to tax earnings received in the form of health insurance coverage or employer contributions to a pension plan. And income support for poor working families has also migrated to the tax code in the form of the Earned Income Tax Credit.

What combination of individual and collective action will produce the true security that we all want?

We ignore this history of multiple programs and heterogeneous techniques at our peril. For by failing to recognize and assess the full range of social insurance coverage now in place, we miss opportunities for making the arrangements more effective. Similarly, some of what we do recognize as social insurance could be abandoned or radically reshaped while maintaining – indeed, improving – current commitments. Conflating the defense of Social Security or Medicare with the defense of the broad idea of social insurance limits our possibilities.

THE FOUNDATIONS OF SOCIAL INSURANCE

Think about three pigs who are not simply fungible porkers, but who have instead lived complex and different lives. Bob Pig, for example, has a game leg and never did very well in school. Bob's participation in the labor force has been sporadic, and his best years have been spent at a large package-delivery company where he has a 30-hour-a-week job with no benefits. Bob has built his house from straw because straw was the only building material he could afford.

Betsy Pig did better in school and landed a pretty good job with an accounting firm. Betsy, however, had two kids who took her out of the labor market for a while. On her return, she needed a job that provided flexible hours, good benefits and a dependable paycheck. She managed to work this out with her employer and settled into a job with a steady, but unremarkable wage. A stick house, Betsy could afford; bricks were out of the question.

Bartholomew pig had well-to-do parents, went to Harvard Business School, became an investment banker and never married. Bartholomew could afford a brick house with ease – perhaps in a gated community.

THE NATURAL EVOLUTION OF PRIVATE INSURANCE

In this revisionist story of the Three Little Pigs, they must cope in varying environments and have radically different backgrounds. But each does face a threat from wolves and would be well advised to carry some insurance. How can they achieve a reasonable level of security? Will private markets permit them to do it on terms they will find acceptable?

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A number of factors limit the private markets' ability to provide reliable and affordable wolf insurance. The threat from huffing and puffing lobos may be so difficult to predict that insurance company actuaries cannot make reliable estimates about exposure, even for large groups. Or, risks may co-vary – that is, rather than Bob's risk being independent of Betsy's and Bartholomew's, wolves may show up in packs that threaten all policyholders at once. If commitments to cover these risks cannot be diversified, private insurance may be impractical.

A pig who has insurance may change her behavior to increase the risk.

If pigs have much better information about their risks of wolf depredation than do insurance companies, the market will be characterized by an insurance demon called adverse selection – the tendency of those at high risk to be over-represented in the insurance pool. If insurance companies charge premiums based on average risks, they will go broke because most of their clients will in fact be porkers at high risk. And if they assume that all buyers are in the high-risk category, their premiums will be very steep – pricing the moderate-to-low-risk pigs, and perhaps many high-risk pigs as well, out of the market.

Finally, many insurance markets are infected by high moral hazard. A pig who has insurance may change her behavior to increase the risk. Thus, with good wolf insurance, Betsy might settle for a straw house, and the well-insured pig community might be inclined to disband the wolf patrol. Moral hazard is almost always present to some degree, but in certain forms of insurance it is so prevalent that private contracts can't be written.

Uncertainty, covariance of risks, adverse selection and moral hazard are the common causes of insurance market failure. The effects of such failure vary from the absence of insurance for certain kinds of risks to high prices and limited coverage for others. Private insurers have developed clever strategies for combating market failure, but such strategies do not always work.

Moreover, the mere existence of insurance does not mean that it will be available on terms or at prices that are satisfactory. The natural dynamic of private insurance is to segment risks in ways that society may well find unattractive. A private insurer cannot insure Bob, Betsy and Bartholomew at the same rate. If a company is so foolish as to try, it will find competitors offering both Bartholomew and Betsy lower rates because they pose lower risks. (Betsy's house was once blown down, but not every wolf will have lungs that strong.)

It is the nature of private insurance to segment the market into homogeneous risks. Indeed, private insurers compete with each other as much by their creativity in segmenting markets and charging differential rates (sometimes called underwriting) as by their service and other attributes of the insurance package.

For many purposes this market segmentation is efficient and desirable. To the extent that high insurance premiums force changes in behavior, such as making horrible drivers drive less or not at all, society is better off. But there is a wide range of circumstances in which mandatory insurance, effectively subsidizing bad risks with the premiums of good risks, also make perfect sense. In particular,

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when the risk to be insured is being out of the labor force, voluntary private coverage has proved spotty and incomplete.

THE MANY REASONS FOR SOCIAL INSURANCE

Market Failure

If the wolf-insurance market is characterized by one or more of the features that cause private insurance markets to fail, but the pig community still wants wolf insurance, it may find that public action can remedy the market failure. Governments have the power to tax and to regulate; private insurance companies do not. Therein lies a world of difference.

In the case of highly uncertain risks, the government can pay compensation when the risks materialize and can impose taxes to pay the costs after they are known. This sort of after-the-fact assessment was the standard technique of the early English burial societies and remains a hallmark of the Lloyd's of London approach to reinsurance. But private attempts to use assessments in group insurance have generally failed.

The taxing (and borrowing) power of government is also critical to solving the problem of covering large risks. A widespread and prolonged wolf infestation can wipe out private insurers; governments are more permanent. They can borrow to meet current emergencies on the credible commitment to tax later to retire their debts. By contrast, private insurers cannot conscript new investors or new policyholders.

Regulation can combat adverse selection and moral hazard. Indeed, in the face of a government mandate that everyone be insured, adverse selection simply disappears. Moral hazard is not so easily solved, even with the power of government – but that power sometimes helps. For example, while the pig community may not wish to ban straw houses when providing wolf insurance, it can limit its exposure to insurance claims by requiring wolf alarms, zoning high-risk dwellings out of forests and increasing the effectiveness of the wolf police.

Market failure provides the fundamental rationale for collective action to tame important community risks. But social insurance also emerges where some forms of private insurance would be available. Here the need is not explained by the market failure, but by the wish to pursue broader social goals.

Solidarity

A society made up of Bob, Betsy and Bartholomew might well decide out of simple moral sentiment to treat wolf insurance as a collective good. As pigs facing ever-present wolf threats, they may see themselves as all in the same boat. It may be unacceptable for Bob, who needs wolf insurance most and can afford it least, to go uncovered.

This desire to treat everyone alike, although they are demonstrably different, is sometimes explained by a social contract metaphor. Think of the pigs as creating the contract about how their society is to be organized before their lives begin. Given little information about where they would start out or end up in the economic order, it may seem in everyone's interest to agree to the collective provision of affordable wolf insurance. And, of course, much of the information they will have in the future, such as Bob's game leg and Bartholomew's plentiful family resources, may seem a morally arbitrary basis upon which to decide who should be left to their own devices.

Obligation

Pigs with lower rates on their private wolf insurance might also feel that they have some

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Too much focus on security can stifle productivity.

obligation to assist their neighbors because their own behavior may actually increase the risks faced by others. Sensible wolves will not waste their time huffing and puffing at Bartholomew's brick house. They will move on to Betsy's, or better yet, Bob's, as likely candidates for producing a porcine meal. Bartholomew's choice of building material is thus not irrelevant to Bob or Betsy's risks.

In addition, the institutions of private property and free markets that produce Bartholomew's wealth – and thereby give him the freedom to build a brick house – also affect Betsy and Bob's situations. If Bartholomew's actions, and the institutions that produce his good fortune, increase the premiums Bob and Betsy face by increasing their risks, they all may feel that he has some special obligation to contribute to their protection.

Self-Regard

Bartholomew may also find that it is in his own interest to help Bob and Betsy buy insurance. After all, in Walt Disney's story of the Three Little Pigs, the pig with the brick house ended up with two long-term guests. Bartholomew may well believe that he will be unable to refuse Bob and Betsy's request for refuge. And he may prefer to contribute to their insurance premiums so that they can live independently, rather than risk having them camp out in his guest rooms.

Paternalism

This self-regarding motivation is closely connected to various forms of paternalism. Pigs at low risk may think those at higher risk should make some provision for a time when the wolf is at the door. But given the latter's low incomes and high private insurance rates, they are unlikely to do so. And given the natural piggy tendency not to value things they can't afford, Bob and Betsy are likely to underestimate the risk of carnivorous windbags as well. Even if they could afford some insurance, they might not buy any.

So if Bartholomew wants the Bob and Betsy Pigs of the world to have insurance and to make a contribution toward their own protection, his best recourse may be to participate in a community-wide social insurance pool. With social insurance, Bob and Betsy will be able to get back on their feet, and they

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will make some contribution to their own protection. Without it, Bartholomew must witness his fellows' suffering and perhaps provide them with a humiliating handout. Or he may find himself stuck with tax bills for a public shelter for pigs whose houses have blown away.

Social Harmony and Productivity

Finally, the availability of insurance to protect against known risks may be an important determinant of the stability and productivity of society. Everybody is better off if Bob and Betsy devote their talents to tasks other than worrying about the wolves, or engaging in armed self-defense that puts others at risk. Moreover, at some level of insecurity, Bob and Betsy will simply be unwilling to support a system that makes Bartholomew fat, happy and safe while they are lean surly, and anxious.

In short, a guarantee of insurance against certain risks may not only free up human resources, it may make it possible to avoid various sorts of regulation – or even more fundamental changes in a society's political or economic organization – that stifle social productivity in general.

It is frequently said that social insurance began as capitalism's answer to Karl Marx. Marx famously believed that the insecurity characteristic of the capitalist means of production – its tendency to drive wage to subsistence levels, the inevitability of workers' losses of income through industrial accidents, unemployment and redundancy – would render capitalist society unstable and unsustainable. Marx thought workers, in the end, would seize the means of production in order to achieve reasonable levels of economic security.

But, as the conventional story goes, Germany's "Iron Chancellor," Otto von Bismarck, was too shrewd. By instituting workers' compensation, and then additional programs of social insurance and labor-market protection, Bismarck and his counterparts in other post-1848 European societies interrupted their capitalist economies' march off the precipice.

With the addition of protection against illness, old age, injury and unemployment, a regulated but relatively free market in labor became bearable for workers. The upside of the market system looked far more promising, once a floor on the downside had been constructed. Thus, Chancellor Bismarck did not pioneer social insurance because he was a softy. Rather, he recognized that in a very real sense the true security of the nation depended upon adequate social insurance for families.

We view all of these bases for social insurance as perfectly sensible – at least in principle. To be sure, paternalism can get out of hand. And social solidarity may be a treacherous foundation for long-term commitments in a changing world: Too much focus on security can stifle productivity, thereby undermining market capitalism rather than sustaining it.

It's worth remembering, too, that market failure justifies state intervention only if government failure is not the predictable alternative. But the possibility of excess should not blind us to the collective good sense of social insurance. Our contention here is just this: the many good reasons for social insurance overdetermine its existence. The primacy of family responsibility for economic well-being notwithstanding, the sensible debate in any society is be about how and how much social insurance to provide, not whether to have any.

Given the multiple motivations for particular security arrangements, we will not spend much energy attempting to unearth the true

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bases of existing programs. For example, we embrace the American commitment to providing social insurance against the risk of impoverishment in old age. But we also believe that social insurance has a larger role here. Youth-poverty risks parallel the risks of destitution in old age. We propose, therefore, a much more active role for social insurance in protecting children's income security.

Nor do we shrink from requiring universal participation. Volunteerism – even highly subsidized volunteerism – will not produce true security. Moreover, putting the young and the old or the rich and the poor in separate insurance pools, as private marketers would, often limits coverage to low-risk populations. True security for all Americans demands that most social insurance programs treat everyone as sharing the same risk characteristics. This means that programs will skew benefits toward those who are unable to pay higher premiums.

The many good reasons for social insurance overdetermine its existence.

Rugged individualism and social insurance are not comfortable bedfellows, and we will not pretend that struggles between liberty and security, or individual and collective responsibility, are not at stake. Our task, therefore, is to convince you that our vision of social insurance puts these competing values into an appropriate balance. No society can have the cake of true security and eat from the full larder of pure individual responsibility.

Following Bismarck, it is also our view that too much is made of this conflict between the demands of the market and the need for security. High levels of economic insecurity do not make people free. And voters will not long support an economic system that relies on a devil-take-the-hindmost approach to those who lose out in the free-for-all of the labor market.

THE COMPLEX AND CONTESTED WORLD OF SOCIAL INSURANCE

We cannot charge ahead to consider possible social insurance arrangements before pausing to examine some more basic questions. What kinds of risks require public rather than private insurance? And what sorts of public action fit the general framework of social insurance?

Life is full of risks. Which are important enough to justify public concern? Where do we draw the line between private and public responsibility?

Viewed historically, the answers are not too difficult to provide. Social insurance in the United States is largely a product of the Great Depression. Before that, economic security was mostly a family responsibility. Family members who became too old to work were supposed to be cared for by the next generation; the pastoral image was grandpa at the fireside waiting to greet his hard-working children and grandchildren as they returned from the fields. Those who became disabled were cared for within the family. Private philanthropy provided assistance in a pinch.

Few private employers took responsibility for the economic security of their workers until workers' compensation legislation made them responsible for injuries on the job. The employer-based pension and health insurance systems that are commonplace today had not yet come into being before the Depression.

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Government generally took responsibility only for its military and civilian employees. A number of states did provide cash assistance for widows and orphans. And a few large employers had introduced pension benefits before the 1930's. But anyone else without an income was supported by relatives or relegated to the metaphoric poorhouse.

Urbanization in late 19th-century America radically changed the reality of family-based security arrangements. But political action was largely postponed until the Depression, when nearly everyone's family income was at risk and no entity other than the national government had the capacity to respond.

President Roosevelt's Committee on Economic Security proposed a comprehensive social insurance to protect against life's major threats to family income. But that scheme was never implemented. Indeed, once history is left behind, getting a handle on the domain of social insurance is not easy. Social insurance has no essence. To define social insurance is thus to argue for a particular conception of it.

THE SOCIAL INSURANCE CONTRACT

Private insurance is usually thought of as a contract to pool common risks so that random economic losses will be experienced as small subtractions from all insured persons' wealth rather than as calamities for a few. Social insurance also pools risks. But social insurance is dependent on government action, directed at a particular class of risks and designed to pursue societal purposes that could not or would not be achieved through contracting in private markets.

Social insurance is not merely a variation on private insurance. But private and social insurance must address some common questions: What risks or events will be insurable? What level of protection will be provided? Who will be covered? How is the coverage to be paid for? And how can insurance protection be structured to limit behavioral adaptations that increase costs, or undermine other goals, or both?

RISKS COVERED BY THE SOCIAL INSURANCE CONTRACT

In a market economy, income is obtained in two ways: by providing labor, and by supplying capital. Most who have capital income have it because of savings from labor income. Thus, the distinctive risk that social insurance must address is the risk of inadequate labor income.

This risk emerges in many forms and in varying intensities. For some, loss of labor income may be complete and permanent. Others may lose income only temporarily, from unemployment or less-severe illnesses. For yet others, the risk occurs as part of the normal life cycle: Both youth and old age exclude one from the labor market.

A LIFE-CYCLE PERSPECTIVE ON RISKS

Indeed, risks to labor income change so substantially over a lifetime that most people view them as different in kind. Children are not expected to work. In early childhood they cannot work, and later they are often limited in the amount they are allowed to do. In childhood, therefore, the dominant threat to income security is the risk that one's parents have insufficient income. Hence, we usually think of the child's risk not as the risk of lacking labor income, but simply of being poor.

During the working years, our concern shifts. Anxieties typically relate to loss of income from illness or accident, loss of a job because of economic dislocation or family responsibilities, or inadequate income because of persistent low wages.

When we consider retirement years, we

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think in yet different terms. In some ways, retirement in old age resembles leaving the workforce through disability or unemployment. Declines in personal physical and mental capacities or changes in the skills the market demands surely explain much retirement behavior. And because this decline happens to everyone who lives long enough, the risk of old age is similar to the risk of youth. Some retirements, of course, seem voluntary – the purchase of leisure time with the fruits of prior work effort.

Whatever the cause, we expect that virtually everyone will experience periods out of the labor force – first as a child, then as an elderly adult. In the latter case, we often conceive of the risk to economic well being not as lost labor income, but as having inadequate savings to support us in old age. But to glimpse how similar this risk is to that of children, remember that in an earlier era we might well have characterized the risk in old age as the risk that our children would be unable to support us.

Social insurance provides quite well for older and retired workers.

Because these risks are thought of differently, they are addressed in different ways and by different programs. Moreover, there are practical reasons for structuring social insurance differently when responding to risks at different stages in the life cycle. Nevertheless, a fundamental unity of purpose lies behind this multiplicity of policy initiatives. Social insurance, operating through direct transfers, subsidies or regulation, alters the distributive consequences that labor markets and private insurance would otherwise produce.

RISKS AND CURRENT REALITIES

While generally successful, American social insurance is a mixed bag. Looking over the life cycle, social insurance provides quite well for older and retired workers, reasonably well for workers in their middle years – but, as the childhood poverty statistics suggest, very poorly for children.

Indeed, looking just at the important cash-transfer programs, American social insurance is dramatically skewed toward protecting the elderly. It provides a relatively small amount to children, modest supports for people aged 18 to 60, and substantial payments to retirees. Inattention to children is not justified by the nature of the risks they face or the capacities of families to provide for their own security.

TIME AND SOCIAL INSURANCE

The categories of risk we have identified here were clearly recognized by President Roosevelt's Committee on Economic Security. But the society and the economy have changed since the 1930's. It is worth reflecting for a moment on how changing circumstances alter both the market risks that families face and the social insurance techniques that might be used to combat those old risks. It also allows us to glimpse how the concept of an insurable event differs in social and private insurance.

THE INCREASE OF WOMEN IN THE LABOR FORCE

Labor-force participation of women has more than doubled since the 1930's. And this massive increase in numbers, along with the impact of their earnings on family economic security, has sharply altered thinking about social insurance.

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Two-earner families have higher incomes and a more diversified "portfolio" of workers than do single-earner families. This can translate into greater capacity to save for retirement or to ameliorate other risks to family income, such as unemployment, illness or death of one wage earner. On the other hand, even though the average incomes of two-earner families have increased, the wages of individual workers have fallen. Full-time workers averaged $440 a week in 1996. Twenty-five years earlier, they had averaged $517 a week in 1996 dollars.

Median family income in the United States in 1996 was $42,300. Twenty-five years earlier it was $40,100 – just 5 percent less.

But the averages masks important differences among families – especially the large differences between one-parent and two-parent families. In 1995, median family income for married-couple families was about $48,000, compared to $31,000 for single-parent families headed by a male and $20,000 for single-parent families headed by a female. The very slow growth in family income in recent decades has not only reduced the insurance effect of having two workers when one must leave the work force, but also has put single-earner families (particularly divorced or never-married single parents) at greater risk.

The importance of the second earner's income to the well being of low- and middle-income families has sharply escalated the opportunity costs of bearing and rearing children. Among other things, the confluence of these trends has made the absence of adequate and affordable child care one of the crucial concerns of late 20th-century American workers – a need that 1930's social insurance planners could hardly have anticipated. They believed that Social Security's Survivor's Insurance, buttressed by Federally subsidized state programs for low-income dependent children, would meet the income security needs of America's children. They were wrong.

STAGNANT WAGES AND RISING RETURNS ON CAPITAL

Other changes of similar import are not difficult to identify. The flat wages resulting from shifts in the labor market have perhaps been reinforced by the globalization of production, and surely by the slump in unionized labor. Meanwhile, returns on capital have escalated.

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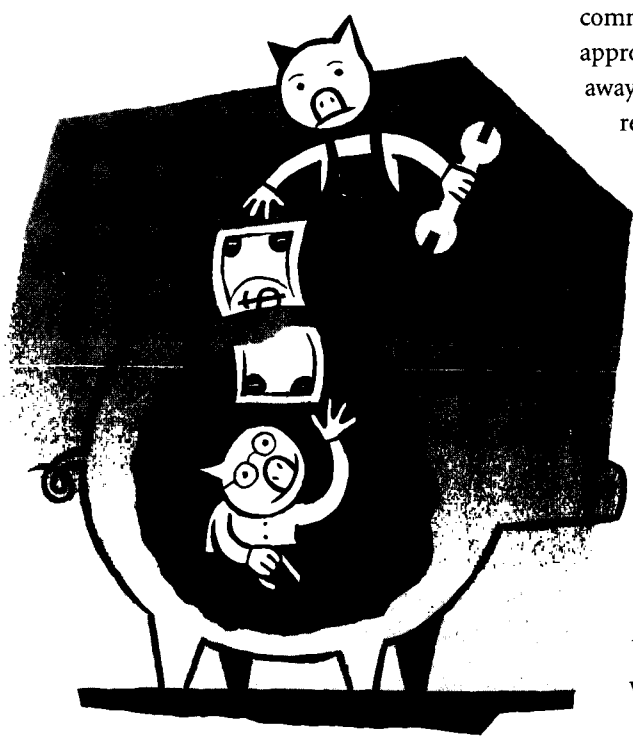
Given these developments, conceiving of family security as turning exclusively on job holding and wage replacement makes ever less sense. Workers need some way to supplement low wages and to connect their long-term security to the performance of both labor and capital markets. Thus social insurance benefits financed solely by wage taxes and calibrated to prior earnings are not effective tools for coping with the risk and reward structures of the contemporary economy.

THE CHANGING NATURE OF EMPLOYMENT

In an era when one wage could support an entire family and workers could realistically expect to stay with a single employer for a decade or more, organizing social insurance around jobs made more sense that it does today. Yet voluntary, tax-subsidized, employment-based insurance has always failed to cover all workers, particularly those most in need of protection. Very few workers have spent their entire working lives with only one employer, and even fewer will do so in the years ahead.



DEMOGRAPHIC SHIFTS

Demography may not be destiny, but it sure sets the agenda. The baby boom, followed by the birth dearth, now influences everyone's thinking about how to cope with an aging population. Add increased longevity to the shift in fertility, and the promises made through Social Security retirement pensions and Medicare look very difficult to keep.

The ratio of the population over age 65 to the working population will increase dramatically beginning in the year 2010. The question is whether private financial markets can provide opportunities to maintain these commitments through alternative financing mechanisms – or, as some have argued, whether changing private financial markets offer reasons to abandon social insurance commitments in favor of radically different approaches. At a minimum, some movement away from pay-as-you-go financing (where retiree benefits are financed by taxes on current workers) toward more pre-funding (where workers put aside amounts to be vested and fund subsequent benefits) seems attractive.

But whatever the effects of changing demographics and family composition on social programs, their effects on families' capacities to provide intergenerational security have been enormous. True security once resided in having a large and closely linked family that could orchestrate transfers – not only from parents or grandparents to children when young, but also from children to their parents when old. Those transfers are still cru-

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cially important, particularly for children. But existing family structures, themselves a response to changing economic demands and social aspirations, have altered our perceptions of how much we can reasonably rely on families.

As birth rates have fallen and divorce rates have risen, average family size has plummeted. Urbanization, industrialization and demands for workers' mobility have sharply reduced the percentage of the population living in extended families – a percentage that throughout American history has been much smaller than popular mythology made it out to be. But whatever the realities of the past, mom is now at work, and grandma is not home to care for the kiddies. More problematic yet, many children must look to the fragile capacities of the law to enforce the support obligations of absent parents.

PRICE INCREASES FOR NECESSITIES

The escalation of the cost of some perceived necessities also changes the way we should think about income security. Because of skyrocketing health care costs, Medicare faces enormous financial problems. Accelerating health care costs will burden the non-aged as well. The result is a combination of increased risk and steadily shrinking private insurance coverage.

The Committee on Economic Security recognized in 1935 that protection against health care expenses was important, but no action was taken. In 1965 Congress provided universal protection for the aged and the very poor by establishing Medicare and Medicaid, but left most working families with whatever protection was available through tax-subsidized, employer-based insurance. At century's close, the non-aged middle class remains the group most in need of relief from potentially devastating health care costs.

Nor is health care the only arena in which family incomes have failed to keep pace with costs. Child care and, for some groups, housing, are big problems. That explains the popularity of subsidies to help fund specific necessities that the social insurance pioneers of 1935 could scarcely have imagined. Current programs offer food stamps and Medicaid for low-income populations, along with a melange of housing and child-care subsidies for the rest of us. The time has come to recognize the common features in these social supports and to ask explicitly what subsidies are really necessary to produce true security for Americans.

WHO SHOULD BE COVERED BY SOCIAL INSURANCE?

Social insurance's aspiration to universalism most distinguishes it from private insurance. The goal of income security applies to the whole of society and across each citizen's whole life. What's more, social insurance is a contract across generations. Universalism in social insurance carries with it some important practical advantages. One is the saving that results from avoiding adverse selection, a dynamic we often see at work in private insurance.

Individual disability insurance, for example, is very expensive because those who purchase it often know things that they conceal from the insurer. Disability insurance becomes much more affordable if it is group insurance organized by a large employer. While buying the insurance is voluntary on the employer's part, once the group policy is purchased, coverage is usually mandatory. This guarantees the insurer that it is not getting a group of self-selected, high-risk individuals.

Universal participation can also limit moral hazard. For example, for many years

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Australia had only a means-tested public pension system. The idea was that most Australians would provide for their own retirement, but some would be needy in old age and participate in the public program. As it turned out, though, most Australian workers found that the annuities they could buy with their private retirement savings provided little more than the means-tested program's benefit. The result was a pattern of spending down savings near retirement, so that the vast majority of retired Australians became eligible for the means-tested program.

The economic well-being of children continues to be left to their parents...a serious but remediable gap in social insurance coverage.

The aspiration to universalism in social insurance has significant implications for our critique of existing programs and our proposals for new ones. First, current reliance on employer-based protection has not produced universal coverage. And, as the changing nature of employment suggests, these arrangements are likely to produce even spottier coverage in the future. In a nutshell, we favor rearranging social insurance expenditures by removing the tax-based subsidies that now support employer-based income security and devoting those funds to mandatory, universal programs.

This need not mean that all employment-based income security arrangements disappear. We would leave the tax subsidies for pensions in place because private pensions supplement the mandatory public pension program (which we would bolster with an additional level of mandatory individual retirement savings). In addition, we favor a tax system friendly to private family savings. But as a general matter, we believe Americans have received a bad bargain from tax subsidies to employer-sponsored insurance.

We have similar objections to programs that leave the financing to the states. Given diverse state political cultures, one could imagine different social contracts in different jurisdictions. But this is generally an inefficient and inequitable approach in a national economy.

After all, most of the policy instruments that affect the performance of the economy are within the exclusive control of the Federal government. The states cannot regulate interstate or foreign commerce, modify the money supply or control migration. Yet all of these bear on the level of economic risk experienced by citizens. And unlike a private insurance company, states that create good social insurance cannot protect themselves from ruinous cost by preventing high-risk populations from moving in.

While the effect of welfare magnets may be oversold in the popular imagination, there clearly are some such effects between neighboring states. Moreover, perceptions matter: Fear of migration can fuel races to the bottom in which the safety net is unraveled in the name of improving a state's business climate.

In short, we believe that devolution of financial responsibility for social insurance is generally a bad idea. Our proposals, therefore, systematically nationalize finance and coverage requirements, but do not necessarily nationalize administration. And when the issue is services (such as job training or vocational rehabilitation) rather than income

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security, localities are often superior providers.

Finally, universalism requires emphasis on the social contract features of social insurance. Promises of income security must be both intragenerational and intergenerational. The returns to the productivity of today's workers must be shared between today's haves and have-nots, as well as between those who are in the labor force and those who are either too young or too old to work.

This is hardly a novel idea. But, surprisingly, it is an idea that has never been systematically applied to the needs of children. Social Security operates on the belief that it is more effective to make all of today's workers responsible for the security of all the previous generation's workers than to make each family responsible for the support of its own elderly relatives. Recognizing the needs of children in the social insurance system requires a parallel shift from believing that the income security of children is solely the responsibility of blood relatives to the belief that the risks to children can, in part, be spread across all families.

HOW MUCH IS ENOUGH?

Clearly, this question cannot be answered once for all time. A society's need for social insurance will change with economic and social circumstances. For example, demographic shifts affect people's need for social insurance. Likewise, how much social insurance is affordable will depend on both national income and competing demands for resources.

Experience with private insurance offers limited insight into this question. In a private insurance contract, the level of insurance is a function of the purchaser's desire for security – for protection from the risks at issue, and the insurance company's concerns about adverse selection (the migration of bad risks toward insurance) and moral hazard (the likelihood that compensation will make the insured indifferent about whether the risk occurs). Private insurance contracts, therefore, rarely provide as much coverage as the insured can afford. Rather, they limit the insurers' potential losses, typically by putting a ceiling on the amount of coverage and by leaving some of the burden of loss on the insured person through deductibles or co-payments.

And in some circumstances, private insurance leaves people significantly underinsured. Individual disability-income policies, for example, seldom provide replacement for more than 50 to 60 percent of lost income.

Social insurance, in contrast, is designed to counteract the what-the-market-will-bear

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limitations of private insurance. It insures people who could not otherwise afford it and it offers coverage in markets where moral hazard and adverse selection render private insurance of limited value. Social insurance can nevertheless face some of the same problems that pervade private insurance markets. Some levels of protection may be unaffordable collectively as well as individually. And because social insurance is directed to the problem of inadequate labor income, it suffers from a peculiar form of moral hazard: the tendency of social insurance to undermine work and savings incentives. Moral hazard in social insurance is a question that we come back to again and again. In our view, the issue explains much of the heterogeneity of existing programs and the need to pursue social insurance through a variety of avenues. But it should be remembered that moral hazard raise difficulties about how to gain true security through social insurance – not about the question of what should be insured.

Ultimately, the answer to the question of how much social insurance is enough turns not only on society's needs and desires, but also on how much we are willing to pay. A society's willingness to pay depends both on what it can afford and, more fundamentally, on how it draws the line between collective and family responsibility. Before the 1930's, Americans regarded the well-being of their elderly as a private family or charitable responsibility. Eventually, however, we came to regard keeping retirees off the streets as a societal obligation.

There is no turning back on that commitment. On the other hand, as we have explained, the economic well-being of children continues to be left to their parents. We view this as a serious but remediable gap in social insurance coverage.

Social insurance must ask how big a shock to current income families can tolerate. Presumably, families can defer larger amounts of current spending over short periods than over longer ones. Thus, we may want to replace higher levels of income for people who are permanently disabled than for those who are temporarily unemployed.

Similarly, we may want to use a lower replacement rate for retirement than for disability pensions because older workers have more time to amass personal savings. Indeed, we may want to require individuals to put aside some of their current wages in personal savings accounts to replace income during unemployment or retirement.

When considering social insurance across families, how much is enough tends to be addressed in terms of some social standard of adequacy and decency. And, of course, there is widespread dispute about what these terms mean. It should be emphasized, however, that social insurance is not judged solely by its capacity to prevent abject poverty. It should protect the incomes of all members of society, not just the poor.

In the end, affordability is a how-high-is-up question to which we offer no special insight. We sidestep the question by imposing a budget constraint on the total cost of our proposed system that is roughly equal to the cost of existing social insurance programs.

To guarantee all Americans true security without breaking the bank, we must be clear about our income-protection goals, and we must design social insurance programs that respond effectively when risks become reality. Much of the foundation for such a system is already in place. But as the third pig discovers to his misfortune in one modern retelling of the tale, a foundation without the house provides limited protection. Despite our nation's affluence, too many little pigs are still being gobbled up.

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Here's our regular listing of interesting economic policy research, gathered from hither and yon. If you reside in hither or yon and would like to send me your own interesting economic policy research, please do (ppassell@milken-inst.org).

MANAGERIAL CAPITALISM, ASIAN STYLE

The public trading of corporate stock decentralizes ownership, creating the lovely checks and balances that make greed-driven capitalism compatible with pluralist democracy. But control and ownership aren't the same thing. And Asia watchers have long understood that control of corporate wealth in industrialized East Asia remains highly concentrated, even though corporations sell stock. They hardly suspected, however, just how concentrated until the completion of a survey of the ownership of 2,980 listed corporations in Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

The study by Stijn Claessens and Simon Djankov of the World Bank's Financial Sector Practice Department and Larry Lang of the University of Chicago, is a trove of plutocratic horrors. In Indonesia and Thailand, for example, two families (the Suhartos and Ayalas, respectively) control 17 percent of total listed corporate wealth. All told, 10 families in each country control half the corporate wealth in Indonesia, Thailand and the Philippines. In Hong Kong and Korea, 10 control one-third of the wealth. Indeed, of the nine countries studied, Japan is the only one without substantial control by a handful of families.

Such extreme insider control suggests how East Asian corporations strayed so far from the Western model of capitalism – why size became so much more important than profitability, and why the return on capital declined sharply in the years before the crisis. But it also suggests how difficult it will be to generate enduring reforms. After all, wresting power from Asia's version of the Mafia will take more than a bunch of new laws. It will, in effect, require a revolution. [*"Who Controls East Asian Corporations," World Bank Working Paper 2054; download free from www.worldbank.org.*]

YET ANOTHER USE FOR JUNK BONDS

By now, everyone – even folks who don't work for The Milken Institute – knows that the rise of the market for less-than-investment-grade debt has dramatically lowered the cost of capital for small- and medium-sized firms. You're excused, though, for not suspecting that high-yield bonds have an incidental, but potentially valuable use as a business-cycle indicator.

Mark Gertler of New York

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University and Cara Lown of the Federal Reserve Bank of New York show that the spread between the yield on high-yield bonds and the riskless rate of interest has considerable predictive power. Indeed, it outperforms other leading indicators including the term spread and the Federal Funds rate. [*"The Information in the High Yield Bond Spread for the Business Cycle." Apply to authors for copies.*]

TAXING CIGARETTES

Who really pays cigarette taxes? More to the point, now that Big Tobacco is on the run, does anybody really care?

Tobacco has been Public Health Enemy Number One for a more than a decade. Yet the financial consequences of the attack on cigarette makers are still far from clear. William Evans and Diana Stech of the University of Maryland, along with Jeanne Rangel of Louisiana State, offer the most serious analysis to date – and their conclusions are disturbing.

For starters, they estimate that every dollar of excise tax increase on tobacco costs the tobacco company stockholders just eight cents. The bulk of the tax – and by implication, the cost of legal settlements in the liability cases – is passed on to smokers in the form of higher cigarette prices.

The people paying those higher taxes, moreover, are an unfortunate lot to begin with. For while just 19 percent of American adults in the top quarter of the income distribution still smoke, 32 percent of those in the bottom quartile are puffing away.

The one saving grace in taxing away the spare change of folks who make $10,000 a year is that the revenue from tobacco taxes offsets costs borne by society as a whole. Actually, earlier estimates had suggested that these "externalities" were modest – and that smokers saved the rest of us a lot of money by dying before they got their share of Social Security pension checks. But Evans and company redo the numbers to include the cost of smoking by pregnant women on their unborn children. And the figure is arguably high

Dreaming About Economic Mobility

Wage equality has risen sharply over the last quarter century, with virtually all the gains from economic growth going to those with marketable skills. Up with computer programmers; down with hamburger flippers. But to many conservatives, inequality driven by the labor market is not a significant problem as long as those hamburger flippers can spend their nights at community colleges learning UNIX.

But do they? The news on that front has been fairly grim. And the latest serious research, by Moshe Buchinsky of Brown and Jennifer Hunt of Yale, doesn't make the picture any brighter. Using 1979-91 data from the National Longitudinal Survey of Youth, they find very little mobility across quintiles of the wage distribution.

Buchinsky and Hunt do identify significant movement within income groups: inequality is cut by 12 to 26 percent when measured over a four-year horizon. But even here the glass is half full. Mobility fell through the 1980's, especially at the low end of the wage distribution. [*"Wage Mobility in the United States," Review of Economics and Statistics, August 1999.*]

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enough to rationalize socking it to the poor. [*"Tobacco Taxes and Public Policy to Discourage Smoking" in Tax Policy and the Economy, edited by James Poterba, Issue 13. National Bureau of Economic Research.*]

MORE ABOUT CIGGIES

Are workplace bans on smoking a clever minimalist use of regulation to reduce smoking? Or are they just a way to make life miserable for nicotine addicts?

A neat new paper by William Evans and Edward Montgomery of the University of Maryland and Matthew Farrelly of the Center for Economics Research at the Research Triangle Institute suggests the former. They used survey data to estimate the impact of workplace bans on smoking, and got surprising results. The bans apparently have reduced smoking by people with jobs by 5 percent – and cut workday smoking among those who have stuck by the habit by 10 percent. Those are huge numbers. Indeed, they would explain virtually the entire decline in smoking among the working population over the last 15 years.

One explanation, of course, is that people who find it easy to quit are more likely to take jobs in smoke-free workplaces. But the authors use solid statistical techniques to rule out that possibility.

Making smoking difficult without making it illegal seems to have had a remarkable impact. Any prospect that similar techniques could replace fines and jail-time in limiting the use of illicit drugs – namely marijuana? [*"Do Workplace Bans Reduce Smoking? American Economic Review, September 1999.*]

Democracy Pays

Wages, explain economists, are determined by labor productivity. Not quite, reminds Dani Rodrik of Harvard's Kennedy School of Government: Political and social institutions also influence rates of pay. Why else do American workers, who are six times as productive as their Mexican counterparts, earn fully 12 times as much?

In this provocative article, Rodrik tests the statistical links between democracy and manufacturing wage rates across 138 countries and finds them surprisingly strong. In the case of Mexico, for example, he estimates that wages would be 25 to 30 percent higher if Mexico were as democratic as the United States.

The big question is why. Rodrik believes (with some evidence to back him up) that democracy improves the bargaining position of labor, allowing workers to shift economic surpluses from profits to wages. It is possible, however, that bargaining power leads to economic inefficiency, reducing total output and benefiting some workers at the expense of others. If this sounds suspiciously like the chronic debate over the minimum wage, give yourself an "A" for acumen. [*"Democracies Pay Higher Wages," Quarterly Journal of Economics, August 1999.*]

THE PRICE OF FALLING PRICES

Just a few years ago the word "deflation" was not in the popular vocabulary. Today, with inflation slipping below 2 percent and Japan perhaps trapped in a downward spiral that looks eerily like the Great Depression, the idea that expectations of falling prices could disrupt the economy is no longer so easy to ignore.

But how could the opposite

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of that great modern evil, inflation, be so bad? J. Bradford Delong of the University of California at Berkeley explains. Interest rates can always adjust to a world of rising prices. But it is impossible to lower the nominal rate of interest below zero. So the real interest rate can skyrocket in the face of falling prices, punishing investment and reducing aggregate demand. What's more, deflation transfers wealth from debtors to creditors, most likely increasing wealth inequality. And it can sharply reduce the value of the collateral that backs loans, undermining the stability of the banking system. Think Japan.

It is still widely assumed that deflation is a very unlikely prospect for the United States. But Delong points to vulnerabilities in our defenses: the vast amount of air in our inflated stock market; the difficulty in using monetary policy, with its long lags between cause and effect, to fight deflationary expectations. Read it and worry. [*"Should We Fear Deflation?" Brookings Papers on Economic Activity, Volume One, 1999.*]

STEADY AS SHE GOES

Everybody knows that the American economy has been growing since 1991. Almost as remarkable, the quarter-to-quarter volatility of GDP has been exceptionally low all the way back to 1984. Margaret McConnell, Patricia Mosser and Gabriel Perez Quiros, economists at the New York Fed, break down the components of output to see what has changed. And the big differences, it turns out, are in the volatility of inventory investment and consumer spending.

Is the change permanent? Certainly the unwillingness of cost-conscious businesses to invest heavily in inventory won't change anytime soon. And, most likely, increases in the efficiency of capital markets have reduced the impact of interest rate changes on residential construction are here to stay. Thus it seems possible that the Goldilocks economy is inherently less susceptible to the business cycle. [*Current Issues in*

One Big, Happy Hemisphere

The Free Trade Area of the Americas, you probably do not remember, was launched at the Miami Summit of the Americas in December 1994. Three and a half years later, in Santiago, the same group of 34 countries reaffirmed its commitment to a regional free trade area. But the hard part – negotiating the nuts and bolts of an agreement that has a prayer of being accepted back home – has hardly begun.

Jeffrey Schott and Gary Hufbauer of the Institute for International Economics assess the chances of getting something done any time soon. While they make a bow to the fashionable pessimism that emphasizes the difficulties of integrating low-income countries into a regional trading system dominated by the United States, they are surprisingly upbeat. They outline a plausible path for getting from here to there. And they emphasize the importance of the process, independent of the result – for the prospect of regional integration could be a strong motivator for Latin economies transforming their state-dominated economies into free market systems.

[*"Wither the Free Trade Area of the Americas?" The World Economy, August 1999.*]

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Defending the Evil Empire

Go ahead, confess.* If you've been following the Microsoft antitrust trial, you've been delighted to watch the software giant take its licks. Who, after all, hasn't been frustrated by the bugs in Windows? And who isn't just a teeny, weeny bit jealous of Bill Gates and his billions?

But not all is fun and games here. If Microsoft is forced to change its aggressive ways, the case could have enormous impact on the market for software. In particular, it could spell the beginning of an era of far greater Government involvement in markets for information technology products – one in which the prevalence of economies of scale and network externalities effectively leave the Government in the position of picking winners.

David Evans, a senior vice-president at NERA, the economics consulting firm working for Microsoft, lays out the argument that the Justice Department has blundered into a battle that shouldn't be taking place. And in the process, he offers a quick and easy tutorial on the economics of the software market. [*"Pick an Argument – Any Argument: The Government's New Economic and Legal Theories in U.S. v. Microsoft," in Regulation, Issue 3, 1999.*]

*While we're all confessing, I should note that I'm a consultant to Microsoft — *PP*

Economics and Finance, Sept. 1999; download free from http://www.ny.frb.org/rmaghome/curr_iss/1999.html.]

BRING ON THE CARBON DIOXIDE

Two years ago at Kyoto, environmental lobbies won a commitment from Europe, the United States and Japan to sharply reduce emissions of greenhouse gases. Global warming, the argument ran, was a clear and present danger that required immediate remedial action.

But Robert Mendelsohn of Yale isn't so sure. Recent changes in the projected impact of warming, he reckons, "are so dramatic that it is not clear whether the net economic effects from climate change over the next century will be helpful or harmful."

So, what has happened to turn the conventional wisdom on its head? For one thing, ecological modeling is now incorporating the positive impact of carbon on agricultural productivity as well as the negative impact of heat stress and more extreme weather on farm output. For another, parallel efforts at modeling the economic effects are becoming more sophisticated, incorporating adaptive behavior that offsets some of the adverse consequences of changes in atmospheric temperature.

The bottom line, suggests Mendelsohn, is that the politics of carbon control are about to become more complicated. The near-consensus for aggressive remedial action by the rich nations is likely to fray. And some developing economies, which have generally opposed efforts to curb emissions, may find that their interests really do lie in collective action.

Of course, yet more research could turn the debate once more. And it seems clear that for at least another decade or two, policy will have to be made in the absence of certain knowledge of the consequences. Anyone for Russian roulette? [*"The Greening of Global Warming," American Enterprise Institute Press. To order, go to www.aei.org.*]

— Peter Passell

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For most Americans social insurance brings to mind Social Security and Medicare for the elderly, and much of the recent public debate has focused on the financing problems those two programs face down the road. The scope of this book is much broader. Michael Graetz and Jerry Mashaw, both law professors at Yale, are concerned with the whole system of insuring against adverse economic outcomes from cradle to grave. Thus, under the rubric of social insurance they include programs aimed at protecting the economic position of children, insuring against unemployment and disability during the working years, providing income in retirement and insuring everyone against illness.

In the first part of the book – the part excerpted in this issue of *The Milken Institute Review* – the authors tackle the philosophical underpinnings of social insurance. They define social insurance as the moderation of the risks of income loss, and ask how we should we divide responsibility for insuring against economic risks between families and the collective. These risks are diverse, but in many respects predictable on the basis of age, social position or genes. Thus, for the more fortunate, individual savings, inheritance and private insurance will usually offer a cheaper, more attractive option.

Even if we mandate universal coverage, is it enough that individuals are allowed to arrange their own coverage – thereby excluding the disadvantaged or those with risks greater than their own? How should we chose between systems of "community rating," in which everyone is assigned the same risk and premium charge, and "experience rating," in which all the available information is used to divide individuals into risk classes?

The latter is attractive as a means of reducing the "moral-hazard" element of insurance because it encourages the efficient use of resources and because it seems only reasonable that those who use more of a service should pay more. Non-economists, however, tend to view efforts to sort out risk as unfairly penalizing individuals for personal characteristics that are often beyond their control. And they tend to be less impressed with the incentive effects created by price differences – as in, "people won't stop smoking in order to obtain cheaper health insurance."

Graetz and Mashaw raise these issues, but they don't really provide new answers. Instead, they argue for a system of universal insurance, but recognize that the risks are too diverse to be met by a single, comprehensive program.

BARRY BOSWORTH is a senior fellow at The Brookings Institution.

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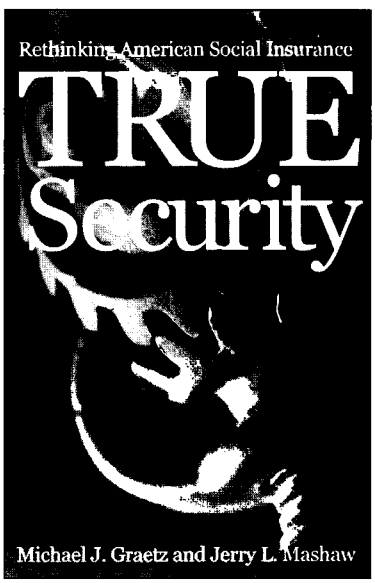
The authors effectively criticize the piecemeal nature of many of the existing programs. Except for medical insurance, however, their suggestions are largely refinements of the current system. They propose to federalize large elements of the financing and they would replace much of the current system of tax-favored, employer-based social insurance. But the book is so broad in its scope that no one proposal is developed in sufficient depth to know how its costs would stack up against the status quo.



True Security: Rethinking American Social Insurance

By Michael J. Graetz and Jerry L. Mashaw

Yale University Press, 357 pp. $40 cloth, $16.95 paper

Reviewed by Barry Bosworth

In thinking more broadly about social insurance, the authors make a very important point: the President's proposal to devote two-thirds of projected future budget surpluses to shore up existing programs for the elderly is goofy in light of evidence of much greater need among the very young. Children, after all, are three times more likely than the retired to live in poverty.

Yet, the incremental nature of their proposals is most evident in the way they deal with childhood poverty. They would keep the current system of the Earned Income Tax Credit and the Food Stamp program, but they would effectively gut Aid to Families With Dependent Children and other forms of assistance. Instead, they propose a new 30 percent Federal subsidy for childcare and housing costs.

An important part of their reform is that they would base the subsidy on a percentage of program costs, not on a percentage of family incomes. They argue that a cost-based subsidy would leave recipients more interested in finding efficient providers, as opposed to a program that pays all costs beyond a certain percent of income. Similarly, they would eliminate the means test for food stamps.

The removal of the income test is desirable from the perspective of strengthening work incentives, but universal programs are very expensive. The authors would convert the current child tax exemption into a tax credit of $1,500 for children under 6 years old and $750 for those under 14. There would be no tax credit for teenagers and the value of any childcare would be subtracted from the credit. Indeed, it is difficult to see any element of social insurance in their program since the new features would be available to all families, regardless of economic circumstance. It would seem to be more appropriately labeled as a family subsidy.

Graetz and Mashaw would replace the current state-run unemployment insurance and workers' compensation systems with federally administered and financed programs. The outline of these programs is very sketchy, but the intent is expand eligibility for unemployment and to eliminate company-specific experience rating of the taxes for both

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unemployment and workers' compensation.

One novel feature: They would create individual retirement accounts, but those accounts would be debited a portion of the cost of any jobless benefits. In fact, if the account were exhausted, future wages could be garnished. Longer spells of unemployment would also be financed at a reduced benefit. The authors do not really address the issue of the definition of short-term disability. This is a significant issue in several states where some policy advocates would like to expand coverage to include pregnancy and family medical emergencies. Without clear dimensions of coverage, it is difficult to attach a cost to their proposals.

Graetz and Mashaw convinced me the issues are too complex to be addressed in a single book.

The authors have little to add to the current debate over Social Security beyond endorsing several suggestions that emerged from the 1994-96 Social Security Advisory Commission. While they support a shift to individual accounts, their proposal lacks specifics about how they would finance the transition from the current system.

Their most concrete proposal is for an increase in the normal retirement age to 70. This is attractive to academics because we could always hang around our offices for a couple more years, and few would notice the difference. It would be necessary, however, to adopt a relatively lenient definition of disability to meet the needs of those with more stressful or physical jobs. At present, employment past age 62 is a significant source of income only for those in the highest paying occupations.

Graetz and Mashaw offer the most substantial reform in the area of medical insurance, where they argue that the current system of Medicare for the aged, Medicaid for the poor and employer-sponsored tax-exempt plans for workers should be replaced by a single mandatory system of catastrophic health insurance. Families would be responsible for the first $3,000 of annual medical expenses and 20 percent of the amount in excess of the deductible up to a maximum of $4,000. They estimate that such an insurance plan could be provided at an annual cost of about $5,000. In addition, they would fully subsidize health insurance for families below the official poverty line, and partly subsidize those with incomes below $60,000.

The idea of universal catastrophic insurance with large co-payments and deductibles has long been popular with economists because it would leave the insured with incentives to economize on their use of health care. However, the approach has generated a notable lack of enthusiasm among the general public – primarily because upper-income families and those over age 65 already have something better. One other quibble: Neither government nor privately provided insurance could operate with an open-ended promise to pay all costs above a ceiling amount. Therefore, a substantial degree of regulation would still be necessary.

The authors are surprisingly blasé about the problem of risk segmentation when they suggest that individuals should be free to choose their providers. Under a system of experience rating, we can anticipate truly wide variations in the costs of programs for people with different health risks – particularly when, as they suggest, insurers could dis-

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criminate between the young and the old.

As they point out, this is not a problem for those in poverty since they envision that the costs would be fully subsidized. But the incentives of a subsidized system with experience rating are likely to severely distort the decisions of the elderly, who could transfer their assets to their children in order to qualify for a free ride. That pattern is already evident in the provision of nursing home care under Medicaid. Even among the working population, the elimination of employer-based insurance pools is likely to lead to increased segmentation of the insurance market on the basis of perceived risks.

Similarly, the authors' suggestion that long-term care for the elderly be provided with a relatively modest insurance premium strikes me as unrealistic. I believe that we would have to anticipate a substantial shift of care from the families to nursing homes. Current long-term-care insurance, as offered by the private sector, more closely resembles a saving plan with a low rate of return.

This book strikes me as simply too ambitious. Graetz and Mashaw make an excellent point when they argue for a comprehensive approach to social insurance. Their criticisms of the gaps and inconsistencies in the current programs are also telling. When they advance their own proposals, however, they raise more questions than they answer and their reforms are not obviously superior to the status quo. In the end, they have convinced me that the issues are too complex to be addressed in a single book.

THE GRAYING OF the baby boomers has given rise to a flood of proposals for reforming the retirement system. This latest, by Sylvester Schieber of the Watson Wyatt Worldwide consulting firm and John Shoven of Stanford University, is two books packaged as one. The first reviews the debate over Social Security from its beginnings in 1935 to its current position as a government behemoth dishing out more than $400 billion annually. Some of this historical material is new and it is presented in a highly readable fashion. But I suspect the audience for tales of notch babies and other social insurance esoterica is limited to retirement-policy mavens.

The book becomes more controversial when it brings us up to date with the 1994-96 Advisory Commission on Social Security, of which Schieber was a member and for which Shoven served on a technical panel. That commission's discussions became increasingly bitter over its two-year life. And the commissioners ultimately fractured into two major groups with sharply differing recommendations, leaving the chairman and one other member stuck in the middle. This portion of the book gets nasty and the authors are not shy about pointing fingers at the guys whom they think wore the black hats.

I take a more kindly view of the commission's deliberations, precisely because the schism highlighted the polar approaches to closing the gap between Social Security's promises and resources. The first would rely on a combination of benefit cuts and tax increases to maintain something akin to the current system in which retirement benefits are tied to individuals' lifetime earnings. While that system incorporates some prefunding of retirement costs, it would continue to rely heavily on pay-as-you-go financing.

Schieber and Shoven favor the alternative of converting the automatic pension to a flat minimum payment and redirecting the remaining contributions into IRA-style savings accounts, in which benefits would be

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tied to investment performance. As memories of stock market crashes fade and commentators emerge to promise ever-higher equity prices, public opinion is, not surprisingly, shifting in favor of the individual retirement account option.

Both Schieber and Shoven have been major players in the ongoing debate over how to restructure public pensions to mesh with the reality of rising life expectancy and declining birth rates. We are fast approaching an era in which many Americans will spend more years in retirement than they did working – and that could get very expensive.

The current program provides income support for 45 million Americans; without it, more than half the elderly would fall below the poverty threshold. But the system is also facing deficits down the line that translate into a one-third reduction in benefits or an equivalent increase in taxes by the time today's 20-somethings reach retirement.

Social Security has three characteristics that loom in any serious discussion of reform.

First, as noted above, it has been financed on a pay-as-you-go basis, without significant pre-funding of future benefits. That decision was made early on, when memories of financial market collapse were fresh and the simple linkage of benefits to the growth in wages appeared to offer a superior financing mechanism. It also provided a means of meeting the immediate needs of the elderly, who could not wait a generation for retirement savings to accumulate.

Second, Social Security is a "defined-benefit" program in which benefits are linked to past earnings, rather than a "defined-contribution" plan in which benefits depend on the investment return of the account. In the 1940's and 50's, a benefit linked to market returns seemed too risky and too far removed from the individual needs.

Third, it is a social insurance system in which the premiums of the fortunate pay a portion of the claims of the unfortunate. This redistribution is the primary rationale for compulsory participation – but it is also a major source of resentment for those who are confident that they will be among the fortunate. It is difficult to incorporate redistribution within a defined-contribution plan in which individuals own their own accounts.

In the most general sense, there are three options for solving Social Security's financing problem. The first two are reductions in benefits or increases in taxes. Benefits could be cut by increasing the minimum retirement age, reducing the cost-of-living adjustment for pension checks or paring the basic benefit guaranteed to low-income retirees. The list of such fixes is long, but they are all elements of a zero-sum game that shuffles program cuts back and forth between workers and retirees. It is hard to get excited about any of the options – though, as I age, I have come to more clearly understand the benefits of raising other peoples' taxes.

The third option would involve finding a means of expanding the resources available to meet the combined needs of both future workers and retirees. That would require increased saving and capital formation today to raise productivity tomorrow. By saving more, each generation would fund a larger portion of its own retirement costs.

Schieber and Shoven suggest a new two-tier system in which the standard benefit is scaled back to a flat monthly payment that is a little less than half the current average benefit. This would free up about 2.5 percentage points of the 12.4 percent employment tax, which would be pooled with a new 2.5 percent tax on wages. The combined 5 percentage points would be used to fund individual defined-

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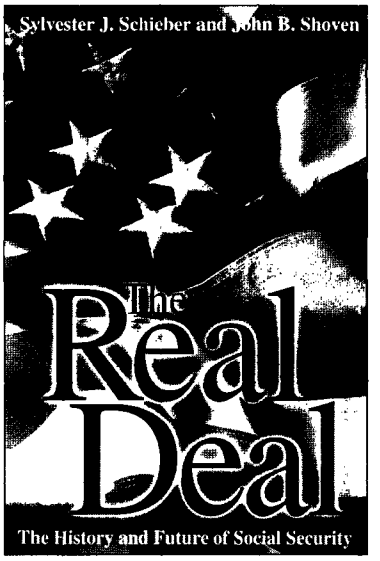
contribution accounts that would be invested in marketable securities. The two economists would have the Social Security Administration manage the accounts with a limited number of investment options, but individuals would also be free to move the accounts to their favorite brokers or mutual funds.

The authors believe that the first-tier benefit would satisfy the redistribution goals of the current system, while the second tier would offer a superior rate of return. Although the first tier would continue to be financed on pay-as-you-go basis, the funded nature of the second tier offers the possibility that the plan would add to national saving and economic growth. That outcome remains uncertain, however, because it would depend on how individuals adjust other elements of their retirement saving. High-income individuals, for example, might logically view the new mandatory saving plan as a substitute for their own IRA or 401(k) plans, and reduce their voluntary contributions accordingly. By contrast, lower income individuals without private pension plans would have no means of avoiding the forced saving.



The Real Deal: The History and Future of Social Security

By Sylvester J. Schieber and John B. Shoven

Yale University Press. 440 pp. Cloth $45.00. Paper $18.95

Reviewed by Barry Bosworth

Schieber and Shoven are also very forthcoming in recognizing the restrictions imposed on any reform by the need to honor existing pay-as-you-go pension commitments. For in the transition to a fully funded system, someone has to pay twice.

Some of those one-time transition costs could be offset by superior returns on investments, but only at the price of increased risk to individuals. Moreover, the cost of the transition would wipe out much of the gain associated with a switch from a defined-benefit to a defined-contribution plan. Thus, even with the conversion to a flat benefit, Schieber and Shoven must incorporate substantial increases in the retirement age to cut projected cost increases. They would index the retirement age to future increases in life expectancy so that the average length of retirement would not change.

In the final analysis, the Schieber-Shoven plan is attractive because it focuses the discussion of reform on the issue of prefunding of retirement while avoiding some of the divisive aspects of the debate over privatization. It will, no doubt, still encounter opposition from those who would like even larger cuts in the tier-one benefit in order to finance larger individual accounts without added taxes. It will draw fire as well from defenders of the current system, who fear that any policy that makes clear how money is being transferred from rich to poor will undermine political support for redistribution.

Is the prospect of disappointing almost everyone a good enough reason to support Schieber-Shoven? Stay tuned.

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It's a man's world, and that goes for business, too. Well, yes and no. Test your acumen below. Those who get all nine answers right win a shard from the glass ceiling of their choice.

1. How many businesses in the United States are owned by women?
a. 3 million
b. 6 million
c. 8 million

2. What fraction of firms in the United States is owned by women?
a. one-sixth
b. one-third
c. one-half

3. What percentage of home-based businesses is owned by women?
a. 15 percent
b. 40 percent
c. 70 percent

4. What percentage of new firms is started by women?
a. 40 percent
b. 55 percent
c. 70 percent

5. What fraction of women-owned businesses begun in 1991 were in business three years later?
a. one-third
b. one-half
c. three-fourths

6. What percentage of women use credit cards to finance their businesses?
a. 28 percent
b. 42 percent
c. 64 percent

7. What percentage of women rely on personal savings to finance their businesses?
a. 30 percent
b. 55 percent
c. 75 percent

8. What percentage of businesses owned by women have assets of less than $25,000?
a. 15 percent
b. 24 percent
c. 42 percent

9. What percentage of businesses owned by women have revenues exceeding $1 million?
a. 1 percent
b. 10 percent
c. 30 percent

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Making soap: so it's cold and dirty, it's mine!
Charlotte Tyler of Warren, Vermont

KURT STIER

Thanks to Glenn Yago and Aaron Pankratz, both of The Milken Institute. The questions were drawn up for the Women's Capital Access Group, co-sponsored by The Milken Institute and the National Women's Business Council.

ANSWERS

1. c. That's a whole lotta businesses, but a disproportionate number are very small.

2. b. See above.

3. c. Nice to know the economy is flexible enough to accommodate working mothers.

4. a. Pretty close to the proportion of the labor force that is female.

5. c. A whole lot higher percentage than for businesses in general.

6. b. The good news is that women can now get credit cards. The bad news is that they have trouble getting small bank loans.

7. a. Most likely, the number is low because women don't save in their own names.

8. c. Have to start somewhere, I guess.

9. a. Makes you wonder about the social constraints on women entrepreneurs.

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Oh fickle public opinion!

Yesterday, Boris Yeltsin was a hero of democracy and the cynical old pack of commies who run China were on the verge of being tossed into the ashcan of history. Listen carefully today, and you hear the faint cries of nostalgia for the certainties of the cold war, when the good guys wore white hats and the bad guys rode around in what looked like 1948 Packards with lace curtains.

But Donald Straszheim, president of The Milken Institute, and Michael Intriligator, a senior fellow at the Institute, aren't buying this feckless revisionism. And in both of their short essays you will detect a plea for patience. Europe took 500 years to emerge from its feudal roots. America managed the transition in a mere three centuries. Surely it is asking too much to expect civil, prosperous societies to spring whole from the ruins of these former socialist paradises.

Russia and the Knowledge Industries

THE SOVIET UNION WAS FAMOUS FOR its economic contradictions. On the one hand, its creaky industrial sector was apparently incapable of producing shoes that fit or televisions that didn't start fires. On the other, its formidable science establishment made the country a leader in technologies ranging from metallurgy to computer software.

Yet in the climate of pessimism engendered by the Yeltsin administration's erratic efforts to introduce free-market capitalism, pundits have focused a great deal of attention on the former and largely ignored the latter. I would argue that knowledge-based development could lead to the revival of the Russian economy and accelerate its integration into the global economy. Indeed, with proper internal policies and external support, I believe that Russia has a chance to become one of the fastest growing emerging markets in the world.

Russia has experienced frightening declines in output and living standards since the dissolution of the Soviet Union. Lacking the will and perhaps the means to halt the downward spiral, it was forced to abandon the peg on the ruble and to default on its foreign debt in August 1998.

Further economic trauma in Russia could have serious consequences not only for Russia but for the world as a whole. There is another reason, though, to care about Russia's economic fate: The West as a whole – not to mention private investors – could benefit enormously from the commercialization of Russia's research and development capacities.

MICHAEL D. INTRILIGATOR is a senior fellow at The Milken Institute.

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To date, post-Soviet Russia's only intensively exploited economic assets have been its natural resources. Energy dominates Russia's exports, generating one-third of the world's natural gas and about one-tenth of its oil. In addition, Russia accounts for 12 percent of world production of platinum, as well as 5 percent of the world's gold and copper.

In contrast, Russia's other great assets, the human capital embodied in its scientists and engineers, and the research institutes that occasionally pay their salaries, have been left largely untouched. A new approach to helping Russia – one that focuses on its scientific and technological potential – could turn that situation around.

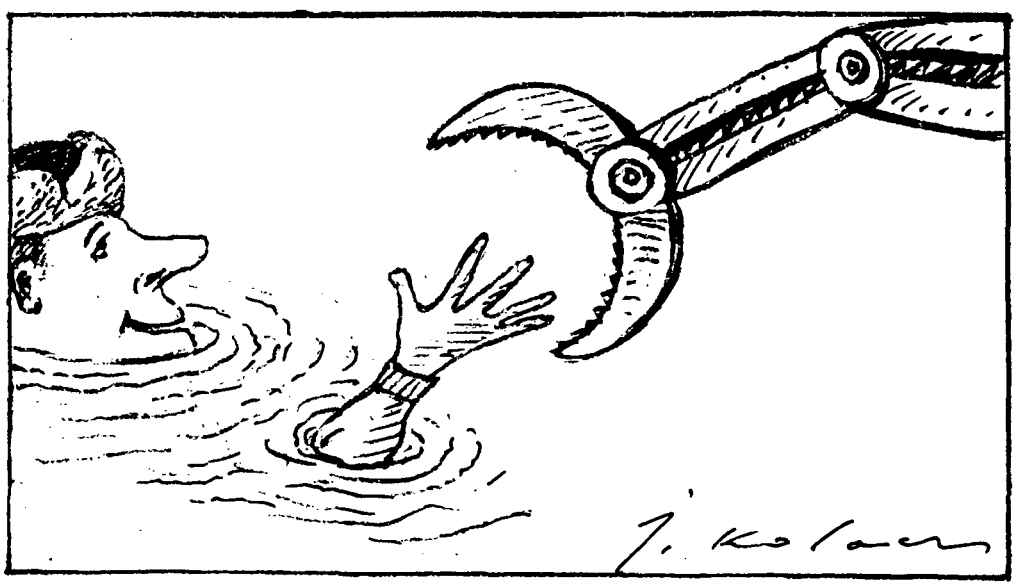
The goal would be to exploit Russia's competitive edge in a variety of areas – notably supercomputer design, "expert system" software, automated pattern recognition, lasers and nuclear fusion. Some Western firms are already collaborating with Russian institutes in those fields. But more is possible.

There is precedent for such collaboration. In the last decade, India has evolved from a backwater to a major center for computer software development. These days, when you call a technical support number, there's a good chance the expert on the other end of the line is sitting in front of a computer terminal in Bangalore.

One path for the exploitation of Russian science is collaboration with Israel. Many Israeli firms already rely on Russian émigrés. And these companies might engage in additional strategic alliances with Russian enterprises and institutes.

Given the uncertainties of utilizing Russian expertise, a modest start clearly makes sense: Russia could begin where it already has a comparative advantage. For example, Russia is a pioneer in methods for the incineration of industrial and municipal waste using garbage as fuel. The technique, superadiabatic combustion, has been perfected at the Institute of Chemical Physics of the Russian Academy of Sciences and has been put into pilot operation in both Russia and Finland.

Or consider another area of expertise: new techniques for earthquake prediction and the identification of mineral deposits that use pattern-recognition algorithms developed by



JERZY KOLASCZ (2)

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Russian mathematicians. This approach has been put into practice by the International Institute for Earthquake Prediction Theory and Mathematical Geophysics in Moscow.

The main missing pieces to using this knowledge – management know-how and marketing skills – could be provided by foreigners. It will also be necessary, of course, to press Russia to build the basic institutions of free markets – protection of shareholder rights, accounting transparency, legal due process and the like.

Technical assistance could be provided through strategic alliances with Western firms. But Russia needs independent access to capital and financing mechanisms. New approaches to financing such development possibly include joint ventures with foreign firms or support from the European Union's ongoing program of technical assistance to the Commonwealth of Independent States.

Will any of this be easy? Hardly. But it would be tragic to waste Russia's unique potential to be a leader in knowledge-intensive industries. And in light of the likely consequences of letting the Russian economy drift further downward, the West really doesn't have much choice. ◼

— *Michael D. Intriligator*

China: Remembering the Bottom Line

As United States - China relations totter over concerns about nuclear-weapons spying, Taiwan's independence and the suppression of civil liberties, it is easy to lose sight of what many consider the bigger picture: China's dramatic economic growth over the last quarter century, and the West's stake in its continuing advance.

For as disturbing as these reminders of China's distance from Western political and social values are, they should not be allowed to drive Western policy. In fact, I would argue that we should redouble efforts to bring China into the fold of developed economies.

The tale of post-Mao China's rise from the ashes, symbolized by Deng Xiaoping's credo "to grow rich is glorious," is a familiar one. Real per capita income in China doubled from 1978 to 1987, and then doubled again by 1996. Today, China ranks as the world's seventh-largest economy measured at market exchange rates, and second largest in terms of purchasing power. No other nation in recorded history gained so much, so quickly.

Deng managed to transform the economy without directly challenging the role of the Communist Party. The West has never been comfortable with the resulting contradictions of Deng's half-planned, half-free market socialism, but it has brought the Chinese a very long way. And while incomplete reforms have left China with a Soviet-style heavy industrial sector and an insolvent banking system, they have probably pushed China down the capitalist road to the point of no return.

As we watch China, we are often disappointed by its leaders' hesitation to tackle the unfinished reform agenda, or to liberalize the political system. But over time the changes accumulate: China has a much more open economy and society than it ever had in the past.

For those who have not traveled into the countryside in recent years, the changes are remarkable. The drab Mao suits are gone. Supermarkets sell barbecued chicken, shrink-wrapped and ready to eat, while everything from toothpaste to rice crackers competes for

DONALD STRASZHEIM is president of The Milken Institute.

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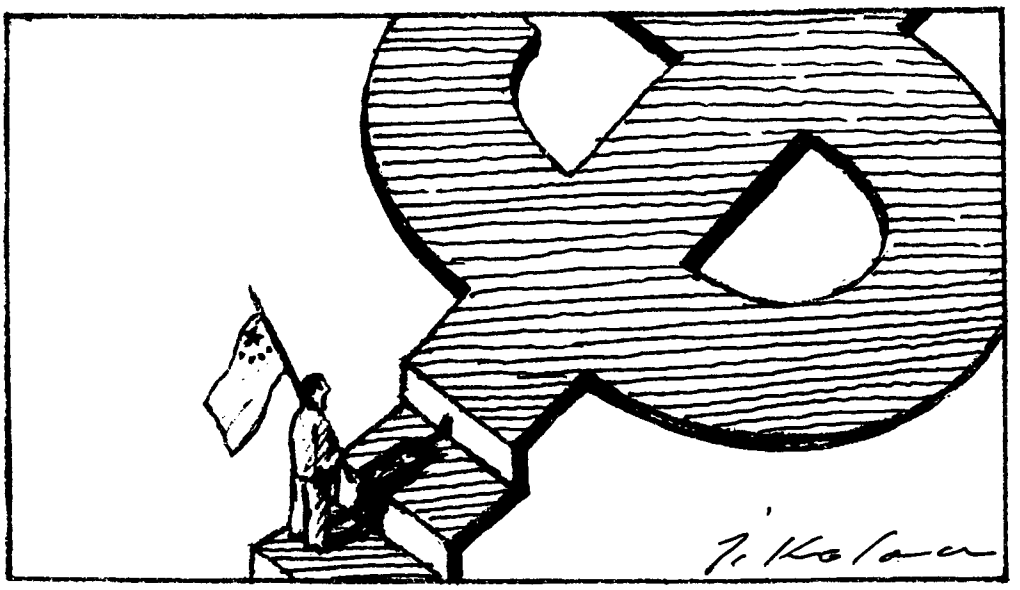

consumers' attention. Color televisions, refrigerators and washing machines have secured a beachhead in Chinese homes. And symbols of American cultural influence – hamburgers, rock music, blue jeans and blockbuster films – are omnipresent.

Perhaps the greatest transformation is in agriculture. Twenty years ago, Beijing set nearly all crop prices; today, the market determines 85 percent of them. The commune system vanished in the early 1980's, replaced by a household contracting system in which land remains collectively owned but individual farmers grow whatever they choose. After giving a mandated portion of the output to the Government and the collective, the farmer is free to sell the rest at whatever price the market will bear.

With higher incomes, direct consumption of grain has been cut almost in half; meat, eggs and dairy fill the gap. The fear of widespread famine in China is a thing of the past.

State enterprises still dominate the urban centers of the north, but the process of dismantling them is underway. And while the West remains impatient with the pace, it's worth remembering that Government-owned factories and farms produced 99 percent of China's output in 1978 – and that downsized state enterprises have laid off 14 million workers just since 1996.

The legal system is developing, with codified, sometimes-enforceable laws that reduce uncertainty and secure property for entrepreneurs, foreign investors and an expanding middle class. Commercial litigation, civil suits and even suits against the Government surface now and then.

Under Mao, the state did the saving. But now private savings have risen to 30 percent of GDP, among the highest rates in the world. Many of the essentials of predictable, sustainable and robust economic growth are not yet fully secure in China – among them open trade, enforceable bankruptcy practices and intellectual property protection. But few in the West would have anticipated China's growth record to date.

It would be a shame if political tensions were allowed to derail an economic transition that has paid such great dividends. Everyone benefits from progress in China. For there are few things healthier for the global economy than a prosperous China that increasingly relies on market principles and procedures. ◼

— *Donald Straszheim*

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ISRAELI FINANCE MINISTER'S VISIT

As part of an ongoing effort to promote economic reforms in Israel, The Milken Institute hosted a private dinner for Israeli Finance Minister Avraham Shochat on Sept. 21, 1999. Mr. Shochat told a gathering of about 50 leading Los Angeles-area business, political and religious leaders that the Israeli economy is strong and growing stronger thanks to the large influx of educated immigrants in recent years, the growth of high-technology industries and the renewed Mideast peace process.

Mike Milken and Israeli Finance Minister Avraham Shochat.

He noted as well that Israel is working hard to reduce government debt, spending and involvement in the economy, while encouraging private investment. This has already paid dividends, Mr. Shochat argued, pointing to the growth in foreign investment in Israeli companies. The dinner was co-sponsored by the Israeli Economic Mission.

NEW STAFF: MICHAEL INTRILIGATOR

Michael D. Intriligator, a professor of economics, political science and policy studies at the University of California at Los Angeles, has joined The Milken Institute as a part-time senior fellow. From 1982 to 1992, he was Director of the UCLA Center for International and Strategic Affairs, the predecessor for today's Center for International Relations. He is a member of the Council on Foreign Relations and the International Institute for Strategic Studies, and was recently elected a foreign member of the Russian Academy of Sciences.

2000 GLOBAL CONFERENCE

The Milken Institute's 3rd annual Global Conference, a three-day, in-depth look at economies and financial markets, is set for March 8-10, 2000 in Los Angeles. Last year's attendance exceeded 1,000 and this year there will be space for 1,500. An edited transcript of the 1999 Global Conference can be found at the Institute's Web site (www.milken-inst.org).

In addition to major addresses by senior policy officials and CEOs, the conference will have general and concurrent sessions on a host of issues ranging from experimental policy initiatives in small economies to the worldwide impact of the Internet.

PETER HALMAGYI

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Publications

Studies released by The Milken Institute last quarter include:

• *America's High-Tech Economy: Growth, Development and Risks for Metropolitan Areas*, by Ross DeVol. DeVol concludes that high technology has become the primary engine of regional growth in the United States – and that cities failing to attract and retain high-tech industries will be left behind.

• *The Jobs/Capital Mismatch: Financial Regulatory Chokeholds on Economic Growth*, by Glenn Yago. Yago argues that the resolution of the mismatch between the sources of job creation and capital formation is America's greatest economic policy challenge of the next few decades.

• *Capital Access Index: Emerging Africa?* by Glenn Yago, Thomas Mims, Juan Montoya, Madani Tall and Christian Yoka. The fifth in the Institute's series of quarterly reports measuring the efficiency of capital markets in countries around the world. This report focuses on countries in Africa and their ongoing problems in joining the global economy.

• *Rethinking Global Economic Incentives: How Mismanagement Keeps World Leaders in Office*, by Hilton Root, asks the question: Why do so many leaders ignore good policy advice about economic development? Root's answer: Leaders are more likely to stay in power if their rule is in their own – rather than the public's – interest.

Publications can be ordered through the Institute's Web site (www.milken-inst.org), or by e-mail (info@milken-inst.org), phone (310-998-2600), or mail (Milken Institute, Publications Department, 1250 Fourth Street, Santa Monica, California 90401).

Michael Milken, chairman of the Institute, will speak. As with past global conferences, the program will include roundtable discussions with distinguished Nobel laureates in economics.

The 2000 Milken Institute Global Conference will be at the Beverly Hilton Hotel. For more information, please visit the Institute's Web site (www.milken-inst.org), or contact the Institute by phone (310-998-2605) or by e-mail (conferences@milken-inst.org).

WOMEN'S CAPITAL ACCESS STUDY

Businesses owned by women are growing at a rate double that of those owned by men, yet women still are having difficulty finding the capital needed to help fund their enterprises. To help bridge that gap, The Milken Institute has joined with the National Women's Business Council to find ways to increase the access to capital for these entrepreneurs.

The two organizations held an initial task force meeting on Sept. 17, 1999, at the Institute. Some 40 leading female business owners, government officials, bankers, community groups, financial executives and participants from The Milken Institute attended the meeting. Among the issues discussed were the prospects for pooling micro-loans for sale in secondary markets, women's access to venture capital and the impact of bank mergers on loan availability to female business owners. The project is expected to result in a series of recommendations that will be published by the Institute in a policy brief next year. M

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Everything I Know About Economics I Learned From Steve Forbes in Kindergarten

NOW, CLASS, OUR STORY FOR TODAY IS CALLED "THE BIG BAD FED."

ONCE UPON A TIME —MEANING NOW— OUR ECONOMY IS GROWING AT A HEALTHY RATE.

BUT IT NEEDS TO GROW **FASTER!!**

AND IT **WOULD** GROW FASTER IF IT WEREN'T FOR A SCARY MONSTER NAMED ALAN GREENSPAN WHO BELIEVES THAT PROSPERITY EQUALS INFLATION.

CHAIRMONSTER GREENSPAN

YES, JOHNNY?

ISN'T THERE A LIMIT TO HOW FAST OUR ECONOMY CAN SAFELY GROW? DOESN'T GREENSPAN'S TRACK RECORD DEMONSTRATE HIS WISDOM?

RIDICULOUS!

HE'S NO ROCKET SCIENTIST! THAT'S FOR SURE!

IF HE WERE, HE'D KNOW THAT OUR ECONOMY IS LIKE AN INCREDIBLY HUGE ROCKET AND THE MORE FUEL WE PUT IN IT THE HIGHER IT WILL GO! SIMPLE AS THAT!

BUT ISN'T HE WISE TO PURSUE A **BALANCED** APPROACH, EMPLOYING THE LESSONS OF EXPERIENCE?

LET ME GIVE YOU A LESSON FROM **MY** EXPERIENCE!

MONEY IS SOMETHING WE'RE BORN WITH AND THERE'S ALWAYS MORE AND MORE AND MORE...

...AND MORE AND MORE AND MORE —WRITE THIS DOWN!—...

...AND MORE AND MORE AND MORE AND MORE

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Yes, that's right.

The caricature on the spine of the first four issues of *The Milken Institute Review* is of David Ricardo, the great English economist.

And just why was he great? Glad you asked.

Born in London in 1772, he left school at age of 14 to become a stockbroker – and by all reports was incredibly rich by his mid-20's. What interests people today, though, is not his proficiency in amassing wealth at an early age, but his contributions to the foundations of modern microeconomics.

Ricardo is associated with the theory of rent, which was based on the observation that a fixed factor of production (in this case, land) absorbed the non-marginal returns. Karl Marx took this one and ran – all the way to his gloomy labor theory of value. Ricardo's theory of comparative advantage explained the gains from trade depended only on differences in the relative costs of factors of production.

Got that? Neither does Pat Buchanan, and neither did most of his contemporaries. But aside from Adam Smith, it is hard to name a more influential thinker in the evolution of free market economics.

DAVID SMITH

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In this issue

JAGDISH BHAGWATI
on the next trade round. Watch out for Seattle.

VIRGINIA POSTREL
on the economics of design.
What a difference technology makes.

STEPHEN MOORE
on speed limits.
The double nickle was a bust.

WALTER RUSSELL MEAD
on development after the Asia crisis.
The end of export-led growth?

JOSEPH POMYKALA
on bankruptcy reform. Too often, it pays to go broke.

BEN BERNANKE, RICK MISHKIN AND ADAM POSEN
on inflation targeting.
There's life after Greenspan.

MICHAEL GRAETZ AND JERRY MASHAW
An excerpt from their new book, *True Security.*

Book reviews by
BARRY BOSWORTH

MIKE INTRILIGATOR AND DON STRASZHEIM
on Russia and China. Looking on the bright side.

A cartoon strip by
MARK ALAN STAMATY,
creator of *The Washingtoon.*

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